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THE JOURNAL OF Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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DIVISION OF BUSINESS ADMINISTRATION

November 1957

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TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Casale reversed: corporate insurance not dividend to controlling stockholder

by EDWIN M. JONES and JOHN F. GLEASON

Close corporations that have insurance to fund deferred compensation and stock retirement agreements have been greatly worried by recent cases taxing the premium payments as dividends to shareholders. The reversal of one of them, Casale, is analyzed here by Messrs. Jones and Gleason. They see in the Second Circuit's decision a return to correct principles in determining the tax effect of these agreements and conclude that abandonment of carefully established plans on the basis of the Prunier and Saunders lower court opinions, now on appeal, is unwarranted.

THE UNITED STATES Court of Appeals for the Second Circuit has just handed down a unanimous decision in *Casale*[1] which reversed the Tax Court's holding and clarifies the tax law with respect to the purchase of insurance to fund deferred compensation and stock retirement agreements. The Court of Appeals held in *Casale* that under a typical deferred compensation arrangement, premiums paid by the corporation for an insurance policy owned by it on the life of a 98% stockholder-employee are not taxable to the stockholder as constructive dividends. By so holding, the court has halted an unsound, contrary trend of the law which was initiated by the Tax Court in *Casale*,[2] fueled by the Tax Court in *Henry E. Prunier*[3] and followed by the District Court of Utah in *Sanders v. Fox*.[4]

In the *Casale* case, the taxpayer-stockholder owned 98% of the stock of the corporation bearing his own name. The board of directors, consisting of himself, his daughter and one employee, authorized the execution of a deferred compensation agreement under which he was to receive a monthly retirement income at age 65. A certain sum was to be paid to a person named by him if he should die before 65. His rights under the agreement would be lost only "if he left the employ of the company against its wishes" which were obviously his own wishes, or if he accepted employment from any competitor of the corporation subsequent to retirement without the consent of the corporation. His rights under the agreement were affirmatively protected by a provision that he would be deemed as continuing in the employ of the corporation until 65 if his employment were in fact terminated (1) by the corporation without fault on his part; (2) because of the corporation's insolvency; or (3) because of any wrongful act or default on the part of the corporation.

On the same day that the deferred compensation agreement was authorized, a retirement income policy was purchased by the corporation from an insurance company in accordance with the board's resolution. The corporation became the owner of the policy in all respects, and at all times was entitled to exercise all rights and to receive all benefits under the policy. The policy provided exactly for the retirement income benefits payable by the corporation to the employee under the deferred compensation agreement.

On these facts, the Tax Court disregarded the corporate entity and concluded that the stockholder-employee's interests in the deferred compensation agreement were to be considered as vested for all practical purposes, with the result that the premiums were taxed to him in the year in which they were paid by the corporation.

The Court of Appeals addressed itself immediately to the Tax Court's conclusion that the corporate entity was to be disregarded, and through Judge Hincks stated its disagreement in the following terms:

"Despite the use of 'sham' and other phrases to characterize the particular transaction under review, the record does not indicate any contention by the Commissioner that the corporation itself is a sham or alter ego for all purposes. If such were the situation the corporate shell would be disregarded for tax purposes. . . . It is clear that we are here concerned with a corporation actively engaged in the business of manufacturing coats in New York City, which had been in existence over two years when the agreement was entered into.

"The finding of 'sham' in this case was based solely upon the fact that the controlling shareholder could direct the activities of the corporation and did so by expediting the corporate formalities and voting himself the benefits described. There is absolutely nothing else in the record indicating 'sham' or a lack of 'bona fides.' "[5]

Then, after discussing another case, the court flatly stated:

"The case at bar is even a clearer one for not disregarding the corporate entity. Here the contract does not require payment over of the proceeds of the policy: the corporate obligation will be satisfied by funds from any source."[6]

No immediate economic benefit

The Court of Appeals then considered the Tax Court's conclusion that the stockholder had received an immediate economic benefit taxable in the year in which the premiums were paid by the corporation. Again, the Court of Appeals tersely disagreed with the Tax Court, stating:

"We think this conclusion demonstrably incorrect. Even after the corporation purchased the policy the taxpayer

[1] Casale, Docket No. 24476, p. 2253-63 of official court opinion (2d Cir. 1957).
[2] Oreste Casale, 26 TC 1020 (1956).
[3] 28 TC No. 4 (1957).
[4] 149 F. Supp. 942 (DC Utah, 1957).
[5] Casale, Docket No. 24476, *supra*, at 2258, 9.
[6] *Idem*, at 2262. [7] *Idem*, at 2259-60.
[8] *Idem*, at 2263.
[9] See Lawthers, *Weakness in Casale Decision: Insolvency Could Destroy Benefit to Owner-Employee*, 5 JTAX 342; Lawthers, *Prunier Offers*

still had nothing more than a contract right to his deferred compensation. At most, the policy indicated to the taxpayer what method the corporation had chosen to enable it to live up to the contract obligation. The policy itself did not inure to the taxpayer's benefit nor was it earmarked for him. If business warranted, taxpayer's monthly retirement payments could have been made from general cash or a special reserve fund. The economic benefit to taxpayer was *not* in the form of a $50,000 life insurance estate, as such, but rather in another new corporate asset upon which he or his executor might levy if the corporation should default on its contractual obligation.

"In any event, there is no warrant for calling the benefit "immediate" for at best it was only tentative. Despite the Commissioner's efforts to show the illusory nature of the forfeiture conditions of the contract (e.g., voluntarily leaving the corporation's employ against the wishes of the corporation) we believe that the corporation's insolvency would have terminated forever taxpayer's interest in the policy (if, indeed, he ever had any interest)."[7]

Finally, the Court of Appeals summarized its views on the necessity of finding an immediate economic benefit and not disregarding the corporate entity in the following succinct fashion:

"We have seen that taxpayer has received no immediate personal benefit from the corporate purchase of the policy. We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person. Reversed."[8]

Casale's significance

The *Casale* case clearly supports the conclusion that insurance may be bought and owned by a corporation to fund a deferred compensation agreement with any employee, even though the employee owns all of the stock of the corporation, without resulting in taxation of the premiums paid by the corporation to the stockholder-employee, so long as the employee's rights under the agreement remain forfeitable, and the corporation's credit alone stands behind its commitment to pay the employee any amounts due under the agreement.

In addition, the *Casale* case has wide ramifications with respect to the tax consequences of a corporation's buying insurance in connection with stock retirement agreements, and with respect to two other cases which have received much attention from lawyers and estate planners.[9] These cases are the *Prunier* and *Sanders* cases in which the Tax Court and the District Court of Utah reached the conclusion that premiums paid on policies owned by a corporation to fund stock retirement agreements constituted taxable income to the stockholders in the year in which the premium payments were made. Judge Hinck's cogent reasoning in *Casale*, we think, provides the answer to the uncertainty created by both cases as to the taxable consequences of the purchase of insurance to fund such agreements.

The facts in Prunier

In the *Prunier* case, the question was whether premiums paid in the year 1950 constituted income to the stockholders in that year. Each of two brothers owned 48.9% of the shares of a corporation, and a cousin owned the remaining 2.2%. Various insurance policies had been issued on the applications of the brothers, with the brothers named as beneficiaries on a criss-cross basis and with ownership rights retained by the brothers, including the right to change the beneficiary. However, there was in effect a 1946 agreement between the two brothers, set forth in the corporate minute book, which specified that the proceeds of the policies "shall go to the corporation in the event of the death of either of them and this money is to be used by the corporation to buy out the interest of the party who dies." The corporation was not a party to the agreement. In addition, there was a resolution adopted by the stockholders and directors of the corporation in November, 1950 which provided that the brothers agreed that the "fair value" of the corporation stock is $110,000, and that it was their "desire" that such value be used to purchase the stock of either stockholder "with the insurance money" should either stockholder sever his connection with the corporation or in the event of death of either stockholder. There were no other facts to establish the fair value of the corporate stock.

The court concluded that "during the taxable year [1950] the corporation was neither the beneficial owner nor the beneficiary of the insurance policies" on the lives of the brothers, and taxed the premiums to the stockholders on the theory that they, and not the corporation, were "enriched" during the year by reason of the corporate payment of premiums.

The facts in Sanders

The *Sanders* case is somewhat similar to the *Prunier* case, but differs in important respects. There, a more formal stock retirement agreement had been executed between four stockholders of a close corporation, two of whom owned from 74 to 86% of the stock during the years in question. The agreement provided that the insured stockholder was to designate the beneficiary. However, the corporation was in fact designated as the owner of the policies with full power to exercise all rights under the policy. The agreement further provided that the price to be paid for the stock would be the greater of the value of the stock as set out in the agreement plus a percentage of the cash surrender value of the policies or the amount of insurance proceeds. By reason of this latter provision, it was possible for the individual to receive insurance proceeds in excess of the fair value of the stock. Moreover, the premiums were to be paid only out of surplus arising from current earnings, if any. On these facts, the court concluded that the individuals were receiving a benefit from the payment of premiums by the corporation and that the premiums should be taxed to the stockholders as dividends paid by the corporation to them.

Does stockholder benefit?

It is our view that premiums paid by a corporation on policies purchased and owned by a corporation to fund a stock retirement agreement should be taxed to a stockholder only if an economic benefit equal in value to the premiums paid, is actually received by the stockholder in the year of payment.

The writers believe that such an economic benefit is not received by a stockholder where a standard stock retirement agreement is in existence, under which the corporation agrees to pay a fair value for stock of a deceased stockholder and purchases insurance policies

No Threat to a Sound Insured Buyout Plan, 7 JTAX 2; Taylor and Maier, *Sanders Case Again Emphasizes Care Needed in Agreements Funded by Insurance*, 7 JTAX 68; Mannheimer and Friedman, *Stock-Retirement Agreements — The Prunier and Sanders Cases*. 35 *Taxes* 567 (1957); Steinberg, *Funding Stock-Redemption Agreements with Life Insurance*, 35 *Taxes* 669 (1957); Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*. 26 Fordham Law Rev. 189 (1957).

on the lives of the stockholders and at all times remains the complete owner and only beneficiary of such policies, the proceeds of which are to be used for the stock purchase.

There is no economic benefit received by a stockholder in such a situation where the corporation pays insurance premiums because the stockholder is in fact not receiving any additional benefit by reason of the purchase of insurance. If in any particular year a stockholder dies, his estate would receive exactly the same amount that it would have received if insurance had not been purchased. On the corporate books of account, the only difference between the corporation owning a policy and not owning a policy would be that it would carry the amount paid for premiums as a "cash" asset instead of an asset entitled "cash surrender value of policies." To impose a tax upon a shareholder in the year in which the premium is paid requires acceptance of the view, which is completely contrary to fact, that the stockholder does in fact personally own the cash surrender value of the policy during the year.

Even if there are only two stockholders and the corporation owns insurance on both lives, and it is expected that one of the stockholders will eventually own the entire corporation, with its assets augmented by the insurance proceeds from the policy on the deceased stockholder, there is no economic benefit to any one stockholder in the year in which a premium is paid because neither stockholder knows who will eventually survive.

Even in the year in which two or more stockholders die, there is no taxable "distribution" made by the corporation merely because the value of the surviving stockholder's stock is increased by the amount of the insurance proceeds that are received by the corporation. It is true that such proceeds may be used, instead of other assets, to pay the fair value of the deceased stockholder's stock, assuming the corporation is not prevented from doing so by paramount rights of creditors of the corporation and that the asset value of the surviving stockholder's stock is thereby increased. However, it is clear that the surviving stockholder does not "realize" any gain by reason of the appreciation in value of his stock. There is no sanction in law for taxing unrealized appreciation in stock values. The Internal Revenue Code itself supports this view. A distribution of corporate assets in redemption of the stock of a deceased stockholder is taxed under the Code as a dividend only if the redemption does not constitute a "complete redemption" or a "disproportionate redemption"[10] or a "redemption of stock to pay death taxes."[11]

The correct result has already been reached by the Service in connection with a stock retirement arrangement in a Special Ruling dated June 27, 1955.[12] There, the Service held that premiums paid by a corporation on a $20,000 insurance policy on the life of one of its officer-stockholders did not constitute taxable income to the employee in the year when paid even though the insurance was bought to fund the corporation's agreement to purchase the stock of the officer at its book value plus an amount equal to one year's salary and a lump-sum cash payment of $20,000. The Service reached the conclusion, even though the wife of the stockholder was named as the beneficiary, because the corporation in the words of the Service, "retain[ed] all the incidents of ownership of the policy" and "the right to again change the beneficiary before the maturity of the policy" and because the stockholder "would have no control over the policy or the benefits if paid to her."

The corporate entity

Furthermore, to tax the premiums paid by a corporation to the stockholders as dividend income in the year in which the premiums are paid requires disregard of the accepted principle of law, enunciated by the Second Circuit in *Casale*, that a corporation must be regarded as a separate entity distinct from its stockholders, where there is a legitimate purpose in organizing the business in the form of a corporation. This principle is not new. Both the Supreme Court and the Service have often acknowledged this principle as being a sound one. In numerous cases, decided by the Supreme Court, the Commissioner has used the doctrine as the basis of his action in disallowing deductions and in assessing additional taxes.[13]

It seems strange that the Service which has used the corporate entity as the basis for its claim in the cited cases, should suddenly insist that the doctrine be disregarded in the instances where it suits its own purposes, such as in *Casale* and *Sanders*. Since it is clear that a corporation is a legal entity distinct from its stockholders, the only way in which the Service can maintain its position with respect to insurance purchased in connection with stock retirement agreements is by proving that the corporate form should be disregarded. The answer has been provided, and the rule crystalized by the Supreme Court in the leading case of *Moline Properties, Inc.*:[14]

"The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying-on of business by the corporation, the corporation remains a separate taxable entity."

The Court then stated the exception to this general rule:

"In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction."

There is no doubt, in the usual close corporation, that there is an essential business reason for the organization of the business in corporate form. The corporation is not usually "sham or unreal." Accordingly, it seems clear that the United States Supreme Court would not sanction disregard of the corporate entity in connection with a validly organized close corporation.

Other courts have expressed the same view as the Supreme Court of the United States in cases involving the question as to whether premiums paid by a corporation on policies of insurance on the lives of 100% or majority stockholders should be treated as taxable income to the insured stockholder or whether the premiums so paid should be considered

[10] 1954 IRC, §302.
[11] 1954 IRC, §303.
[12] CCH 1954-55 Fed. Tax Rep., Transfer Binder, New Developments Under 1954 Code, §37347.
[13] In Dalton v. Bowers, 287 U.S. 404 (1932) the petitioner was the sole stockholder in a corporation which became insolvent. In his personal income tax return, the petitioner deducted the amount paid for his capital stock as a loss "attributable to the operation of a trade or business regularly carried on by the taxpoyer." The deduction was disallowed, the U. S. Supreme Court holding that the loss was suffered by the corporate entity and not by the taxpayer. The reasoning in this case was followed in DuPont, 308 U.S. 489 (1940) which arose on similar facts. Again, in Commonwealth Improvement Co., 287 U.S. 415 (1932) the idea of the corporate entity as a separate taxpayer was upheld by the Supreme Court. A profit made by a corporation on a sale to its sole stockholder was held taxable to the corporation even though there the conceded purpose of incorporation was to avoid multiple death taxes. In National Carbide Corp., 336 U.S. 422 (1949), the petitioner was a wholly owned and controlled subsidiary. The contract between the parent corporation and petitioner provided that the latter was employed as an agent to operate a plant built by the parent, and to sell the output of the plant. Petitioner agreed to pay

as having been paid by the stockholder for the purpose of applying the premium payment test in estate taxation.[15]

It is also an accepted principle of law that the purchase of insurance by a corporation on the life of its active stockholders constitutes a legitimate use of corporate funds.[16]

On the basis of the foregoing analysis, we believe that a standard stock retirement agreement under which the corporation agrees to purchase stock of a deceased stockholder at a fair value with insurance proceeds of a policy purchased and owned by the corporation and of which the corporation is the beneficiary, should not result in taxation of the premiums to the stockholders as a dividend in the year in which paid.

What the three cases mean

The principal difficulty in understanding the meaning of the *Prunier* case arises from the statement in the dissenting opinion that the majority of the court might have reached the same result even if the corporation had been the named beneficiary, and presumably the owner. Since the majority opinion cited and relied upon the Tax Court's opinion in *Casale* in connection with this point, there would now appear to be no proper legal basis for such a conclusion. It is to be hoped that the Court of Appeals in its decision will make this clear.

In *Sanders,* the district court's holding seems wrong as a matter of law. There the corporation owned the insurance policies, and the stockholders would receive the proceeds as beneficiaries only upon surrender to the corporation of their stock. The fact that a particular stockholder might in some future year receive proceeds in excess of the value of the stock under a provision in the stock retirement agreement that provided for stockholder's receipt of the proceeds if such proceeds exceeded the value of the stock, does not provide a proper basis for taxing the premiums to the stockholder as a dividend in the year in which the premiums are paid, absent any excess of insurance protection over the stock value in that year. Furthermore, the fact that a ready market might be provided for the stock upon the stockholder's death, which the court appears to have relied upon in reaching its result, does not provide a sound basis for finding a taxable economic benefit to the stockholder in the year of premium payment. Such a "benefit," if any, is so uncertain, and contingent upon so many factors, that it cannot be measured and given a taxable monetary value.[17]

With respect to the *Sanders'* opinion, the significance of the reversal of the Tax Court's opinion in *Casale* seems even more pointed since the District Court of Utah in *Sanders* said that "the pivotal point for decision in this case is whether the stockholders, the corporation or both, derive benefits from the corporation paying the premiums on the insurance issued on the lives of the stockholders in accordance with the terms of the agreement."[18] The court then cited and quoted the Tax Court in *Casale* to support its holding that for "all practical purposes" the four stockholders were "the" corporation. Hence, it would appear that the legal basis upon which the district court decided "the pivotal point" no longer exists.

Furthermore, both courts in *Prunier* and *Sanders* cited and relied upon *Paramount-Richards Theatres Inc.*[19] The facts in *Paramount-Richards* were peculiar, however, and significantly different from the facts in the usual standard stock retirement case where the corporation is the owner and beneficiary of the insurance policies.

In *Paramount-Richards,* the corporation paid the premiums on a $250,000 life insurance policy on the life of one of the stockholders. The proceeds were made payable to the wife of the stockholder and the stockholder had the right to change the beneficiary. Under an agreement between the two stockholders of the corporation, to which the corporation was not a party, the insured was to receive an amount determined by a formula plus $125,000 if no insurance was procured on his life, but only the amount determined by the formula if insurance was procured. However, in the latter event, the insured would have received $250,000 of insurance in addition to the amount determined by the formula. Thus, the non-insured stockholder was going to pay $125,000 less if insurance of $250,000 was procured, and the insured stockholder was to receive $125,000 more if the insurance was procured. On these facts, the court concluded that the insurance was for the benefit of the two stockholders equally, and accordingly taxed the premiums to them. Such a result is supportable because the stockholders were clearly receiving benefits in the year in which the premiums were paid. The surviving stockholder and the insured stockholder's estate would each profit by $125,000, which was not the case in either *Prunier* or *Sanders.* There was no need to pierce the corporate veil since the beneficiary was the wife of the stockholder and the proceeds would not at any time become a corporate asset.

Accordingly, it does not appear to us that the *Paramount-Richards* case decision affords any basis for the possible implications in *Prunier* and *Sanders* that a standard stock retirement agreement justifies taxation of premiums paid by a corporation to its stockholders. We are fortified in our thinking on this point by the Court of Appeals' opinion in *Casale* in which it was pointed out that the Commissioner had argued that the situation in *Casale* was not legally distinguishable from the situation in *Paramount-Richards.* The court dismissed this argument with the observation that it overlooked the impact of bankruptcy on the situation in *Casale* and the fact that in *Paramount-Richards* the policy belonged to the individuals and could not have been reached by corporate creditors.

Should existing stock retirement agreements be revised in the light of the courts' language in *Casale, Prunier* and *Sanders*? Generally speaking, it would seem prudent to review stock retirement agreements and to make sure that the corporation is, in fact, the owner and beneficiary of any insurance that has been purchased to provide funds with

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to the parent all profits in excess of 6% of its capital stock. The court upheld the doctrine of the corporate entity and ruled that the profits of the subsidiary were taxable to it. In this case the Supreme Court made this important statement at page 429: "Complete ownership of the corporation and the control primarily dependent upon such ownership . . . are no longer of significance in determining taxability."

[15] 319 U.S. 436, 438-39 (1943).

[15] Bonwit, 87 F.2d 764 (2d Cir. 1937); Wilson v. Crooks, 52 F.2d 692 (DC Mo., 1931); John C. Morrow Estate, 19 TC 1068 (1953); John Randolph Hopkins, 15 TC 160 (1950); Mrs. Matney Dyer Lucey Estate, 13 TC 1010 (1949); Edward Doerken Estate, 46 BTA 809 (1942); Harry W. Hahn Estate, 38 BTA 3 (1938). See also Doran, (9th Cir. 1957); Canaday v. Guitteau, 86 F.2d 303 (6th Cir. 1936); J. H. McEwen. 6 TC 1018 (1946).

[16] Emeloid Co., 189 F.2d 230 (3d Cir. 1951); Edgar M. Docherty, 47 BTA 462 (1942).

[17] See William Parria, 20 BTA 320 (1930); cf. North Texas Co., 281 U.S. 11 (1930); Edwards Drilling Co., 95 F.2d 719 (5th Cir. 1938); Helvering v. Walbridge. 70 F.2d 683 (2d Cir. 1934).

[18] 149 F. Supp. 942, #946 (1957).

[19] 153 F.2d 602 (5th Cir. 1946). Compare N. Loring Danforth, 18 BTA 1221 (1930); G.C.M. 16069, XV-1 C.B. 84.

which the corporation may buy the stock of a deceased stockholder. Existing agreements should probably be revised to delete any provision permitting the corporation to exercise its right of ownership only with the written consent of all of the stockholders. In addition, consideration might be given to the omission of any provision committing the corporation to pay a minimum of any insurance proceeds received by reason of the death of the stockholder for the deceased stockholder's stock, or of any provision giving a stockholder the right to purchase a policy from the corporation upon the termination of the agreement for reasons other than the death of a stockholder, or upon the failure of the company to pay premiums for the policy.

These same precautionary actions would seem to be worthy of consideration in the drafting of any new stock retirement agreements funded with life insurance.

The protection afforded by a written agreement binding the corporation to purchase stock at a fair value and by the purchase of insurance policies should not be lightly and indiscriminately dispensed with by stockholders solely on the basis of language in two lower court decisions, which espouse a result that is contrary to accepted principles of law giving full recognition to the corporate entity as a separate taxable entity. Thousands of stockholders throughout the United States have relied upon these principles for many years and any hasty action in the light of the *Prunier* and *Sanders* cases, both of which are on appeal to higher courts, would seem unwarranted, particularly in the light of the Court of Appeals decision in *Casale*.

Incorporating a partnership: choosing the structure for future tax advantage

by MARTIN H. WEBSTER and DONALD T. ROSENFELD

When the decision has been made to incorporate the going business of a successful partnership, the taxman has a unique opportunity to choose a form of organization that will not only keep taxes low in the near future, but will also fit in with the partners' long-term retirement and estate plans, plans for family gifts and for shifts of control to others. Messrs. Webster and Rosenfeld were two of the speakers at the 1957 Tax Forum sponsored by the Title Insurance and Trust Company, Los Angeles. Each speaker at the forum considered a different aspect of the estate planning problems of the owners of a typical business operated as a partnership. The facts of the case they considered are set out in the box on page 263.

Capital structure: common and preferred stock

THE ADVANTAGES and the problems in using preferred or debt, particularly in the light of recent cases on thin incorporation, are considered by Martin H. Webster, California attorney. Here are his conclusions:

Once the decision has been made that a corporation should be formed, it is next necessary to ascertain the amount of stock to be issued, of what classes it will consist, and the ratio which such stock is to bear to any indebtedness which will be owed to the shareholders. It is with these questions that we shall now deal.

Obviously, it is possible to take the assets of the A-B partnership, and its liabilities, filter out those which are to be selected for transfer,[1] and convey them to a corporation for common stock to be issued in proportion to the relative contributions of A and B. Whether the common stock has a face value greater, equal to, or less than the net book value or net market value of the assets transferred, the transfer will be tax-free, and the corporation will take over the assets with a substituted basis.

This program without question has the virtue of simplicity, and it might be that we shall return to it again. In the meantime, other possibilities should be explored.

One ready alternative would be to issue preferred as well as common stock in exchange for that portion of the partnership property determined to be transferred. While it is known that dividends are non-deductible, the purposes of issuing preferred as well as common stock might include one of the following:

1. To enable the book value of the common stock to be reduced so that a significant percentage thereof could be bought by the key employees at a price within their means.

2. Upon the death of A or B, to reduce the amount which would have to be paid for the common stock holdings of the estate in order that a transfer of voting control to the survivor might be effected. (Note that our statement of fact calls for such transfer of control.)

3. Upon death of A or B, the preferred could be redeemed to provide the estate with cash needed for death taxes and administration expenses without disturbing the percentage of ownership of the corporation in the hands of the estate. (While our statement of facts calls for transfer of control on death, the utility of a preferred issue for the purposes here indicated should be pointed out to A and B).

4. If it is *ever* contemplated that preferred stock will be issued, the time to issue such stock uncontaminated by Section 306 would be at the moment of incorporation.

5. To provide the estates of A and B with a more assured source of income from the corporation than could be obtained through retention of an equivalent amount of common stock; and to provide the estates with a preference to assets on liquidation or in the event of financial difficulty.

6. To provide an excellent vehicle for a gift program, concerning which B if not A should have singular interest, and to thereby enable the donor to reduce his taxable estate without loss of voting control during lifetime.

7. To enable earned surplus to be drained off through preferred dividends to the estate; the survivor may avoid receipt of this unwanted ordinary income through gifts of dividend-earning preferred stock.

[1] Mr. Rosenfeld discusses selection of assets. If, in the selection of assets to be transferred, it is determined that the land and buildings will be withheld—an assumption which will be made throughout this paper, unless otherwise noted—A and B wil rent them to the corporation. At a later date they could sell them to the corporation when the corporation is more able to pay, or to a third party.

[2] See Young, "Problems in Organizing and Capitalizing New Corporations," 14 N.Y.U. Tax Inst. 613 at 620.

Any one of these reasons alone might conceivably appeal to A and not to B, or vice versa. Were this lack of concord found to exist, further discussion would obviously be required in order to see whether the two-class structure would for that reason be ruled out. However, from a tax standpoint, *any* amount of common issued in conjunction with *any* amount of preferred and in *any* proportion as between A and B would still be tax free, absent the element of gift or compensation as between A and B. Respecting the price at which a given face value of preferred might be issued, there might be some tax advantage at a later date in issuing the preferred at a discount.[2]

THE BUSINESS TO BE INCORPORATED

MESSERS WEBSTER AND ROSENFELD were given the following data on the financial position of the partnership and the general family plans of the partners:

A and B are equal partners of the A-B Manufacturing Company from which, over the past three years, they have each realized average profits of $40,000.00. Since its inception the company has shown a steady growth and the partners in the past have reinvested approximately 25% of the net profits to expand the business.

The current balance sheet of the business is as follows:

Current assets	$100,000	Current liabilities	$150,000
Land & Buildings (net)	100,000		
Mfg. Equipment (net)	250,000	Net worth	300,000
	$450,000		$450,000

The fair market value of the the assets is $600,000.00.

Each individual is fifty years of age and in good health.

A is married, has one son active in the business, two married daughters and one grandchild. B is married and has two daughters, neither married.

A and B are desirous of assuring continuity of the business under the control of the survivor and two key employees so that the future growth, which each anticipates, will be available for the benefit of their respective families.

Although the business has in the past been confined to California, potential markets in other states are beginning to develop.

Previous speakers at the forum had discussed the influencing factors to be considered in determining whether to continue the partnership (perhaps bringing in other members of the family or trusts for them as partners) or to incorporate.

Using preferred stock

It would appear to serve no useful purpose at this time to dwell upon the redemption, liquidation, dividend, sinking fund and other characteristics with which the preferred stock—if issued—could or should be endowed. These would vary widely and would require much discussion and deliberation. However, two characteristics would appear definitely to be required, and should be mentioned.

The first of these is that, in line with the requirements of our statement of facts, the preferred (especially if the estates of A and B will surrender all their common stock) should have the feature of allowing its holder to participate in the growth of the company, and this result could be achieved through participation of the preferred with the common in dividends and in the excess of assets on redemption or liquidation over those to which the preferred is to have preference.

The second necessary characteristic of the preferred is that it should provide for a deferral of dividends for some time. This is so by reason of the arithmetic of our case. If we project a rental of $20,000 per year for the land and building which we have presumed has been withheld by A and B from the corporation,[3] and if we project a salary of $20,000 per year to A and a like salary to B, this salary plus the rental income will equal the drawings of A and B from the partnership. The corporation itself can safely be projected to make $85,000 per year (the partnership $80,000 plus the estimated partnership depreciation on the building which is not being considered part of the corporation's assets), from which must be subtracted the above rent and salaries aggregating $60,000. On the remaining $25,000 will be owed corporation income and estimated franchise taxes of 34%; and there will thus be left in the treasury only $16,600 per year. If we project a $100,000 preferred issue carrying 6% dividends, there will be left for expansion and growth only about $10,600 per year after servicing the preferred dividends. With the policy of A and B in mind of dedicating about one-fourth of their earnings—or $20,000 per year—for expansion (let alone providing any sinking fund requirements on the preferred or covering the working capital deficit to be discussed later herein) it is apparent that preferred dividends would have to be deferred for a time. This should be no hardship.

There is still the fundamental question to be answered as to whether the preferred stock issue is a good idea in our case. Aside from the obviously inhibiting fact that the preferred dividends are not deductible, the decision in this particular case, as in most others, turns to a large extent on whether A and B, or either of them, are "gift-minded" and "death-minded." On the basis of our statement of facts, it would seem that a preferred stock issue is indicated, but final determination would have to await the analysis of additional factors.

Transfers creating debt

The extent to which a corporation borrows money at the outset of its existence relative to the extent it receives a permanent investment establishes its relative "thinness." If all is invested, there is obviously no thinness at all. If $1 is invested and $100,000 is represented by debt obligations, a corporation is very thin indeed! A corporation may be formed through transfers which are tax-free, or are partly or wholly taxable,[4] and indebtedness may be created under any of these transfers.

If a business is transferred to a corporation so that part of its value is represented by a debt obligation of the corporation and part by stock, the advantages

[2] This is 8% of the assumed fair market value of $250,000.00. In this illustration, we are also assuming the corporation will earn enough over its otherwise projected earnings to pay for taxes and insurance on the property, and that the $20,000.00 rental is thus on a net net basis.

[3] This problem is discussed by Donald T. Rosenfeld. It would seem that a taxable incorporation on our facts would be undesirable.

[4] Under Putnam, 352 U.S. 82 (1957), the deduction will be a non-business bad debt in most cases, resulting in a short-term capital loss.

over having the entire value represented by a permanent investment in the form of stock are:

1. With a loan, interest is deductible. With stock, whether preferred or common, dividends are not deductible.

2. Repayment of a loan out of earnings is tax-free. An equivalent partial redemption of stock out of earnings constitutes ordinary income.

3. A loan gives protection against a charge of unreasonable accumulation of surplus under Section 531. Stock does not.

4. If the business is unsuccessful, a loan will give a bad debt deduction, probably a short term capital loss.[5] Stock will only give a worthless security deduction, i.e., a long term capital loss.

5. If the debt is the result of a taxable transfer, the corporation can get a step-up in basis at the expense of capital gain to its stockholders, often a worthwhile result.

6. A debt obligation can be given away, thereby enabling corporate earnings to be received by other members of the family without loss of control or proprietorship interest by the donor. The gift of stock, even of preferred, can mean a loss of control, and certainly a loss of a participating proprietorship interest in our case.

There can be disadvantages to a corporation having debt built into its initial financing structure. Some of these disadvantages are:

1. The Treasury Department might not recognize the particular instrument as creating a true debt. The results of such non-recognition will, at a minimum, be disallowance of the interest deduction and taxation as a dividend of the "loan" repayments if paid from earnings and profits. Non-recognition will also create intriguing questions such as the effect of a transfer for consideration of the "debt" obligation to a third party. In addition, whether the transaction is tax free or taxable will turn upon whether the particular instrument will be deemed a non-debt and therefore a "security" within Section 351, and hence to be received tax free upon incorporation;[6] or whether it will be construed as a true debt or non-security[7] and hence "boot," taxable to the recipient.

2. This doubt as to which way a particular instrument will be construed is seldom resolved by determining the intention of the parties. More often, it seems, it turns upon which construction will produce the most tax revenue.

3. Creation of a debt structure can adversely affect a corporation's credit. This disadvantage might be removed through the giving of personal guarantees by the individual stockholders, a not very salutary solution, to be sure, but one which lending agencies might insist upon in any event.

4. One non-tax disadvantage, not often mentioned, stems from the *alter ego* principle and can result in a disregard for local law purposes of the corporate entity where the capitalization is inadequate to finance the anticipated corporate business.[8]

When it is remembered that the above consequences only become known several years after the transaction has been set up and actions in reliance thereon might have been taken, it can be seen under what false clouds taxpayers can live who reach for the expected advantages of an initial capitalization which includes debt.

In the instant case, if it is agreed that the land and building will be kept out of the corporation, much will have been done to reduce permanent investment without creating any false-named debt. It is worthwhile, however, to explore further alternatives.

Arbitrary "thinning"

An obvious way to achieve a thin capitalization is to determine, more or less arbitrarily, that of the total amount of net book value (or net market value) of the property to be transferred to a corporation, a certain portion will be represented by stock and the balance by debt. This is certainly not a preferred method for thinning, since the reason for the debt structure and its amount is, by definition, not tied into the economics of the particular business nor endowed with business purpose.[9] However, while it has been said that the ratio of debt to equity is only one factor in determining whether a debt is in fact a debt,[10] it must be admitted that no court[11] has yet assayed to state how to test the question of whether there is an "excessive debt structure."[12] Certainly, the general current of opinion is that if thinness is to be tested solely on the reasonableness of debt to equity ratios, a ratio of two to one would be a hallmark of authenticity for even a risky business.

However, the facts in the instant case make thinning in any respect a bit difficult. If $25,000 is reserved by A and B to pay income taxes, contingent liabilities and the like, the balance sheet of the corporation would show:

Current assets	$ 75,000	Current liabilities	$150,000
Equipment (net)	250,000	Net worth	175,000

The imbalance between current assets and current liabilities means that earnings will have to be accumulated first merely to meet those liabilities which were on the books at the time of incorporation before any earnings can be used to pay off an indebtedness created incident to the initial transfer of the business to the corporation. Specifically, if (arbitrarily) notes or bonds were issued for $100,000 and stock issued for $75,000 (a ratio of 1⅓ to 1) it would take a considerable period of time before the corporation could ever commence paying on the $100,000 obligation, since it meanwhile must make up the $75,000 working capital deficit with which it began business.

Repayment problems

Under this state of affairs, it is likely that a thin corporation structure, at least one created in the manner now being discussed, would strongly invite revenue agent scrutiny. While the ratio of debt to equity could be made reasonable, the question of how repayment could be made would be the substantial stumbling block to recognition of the debt.[13] Of course, at this point the tax adviser might well ask himself

[6] See, e.g., Camp Wolters Enterprises, Inc., 230 F.2d 555 (5th Cir. 1956) where non-negotiable, unsecured and subordinated installment notes with five to nine year maturities were held securities.

[7] See, e.g., Pinellas Ice & Cold Storage Co., 287 U.S. 462 (1933).

[8] Automotriz Del Golfo De California, 47 A.C. 797 (1957). See generally Schifferman, "The Alter Ego," 32 Calif. State Bar Journal 143 (1957) at 155. The cited case quotes from Ballantine on Corporations, revised edition 1946, pages 302-303 as follows: "If a corporation is organized and carries on business without substantial capital in such a way that the corportion is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability . . . It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." (The author has been unable to find a comparable passage in Ballantine's 1949 edition.)

[9] Ruspyn Corp., 18 T.C. 769 (1952).

[10] Gooding Amusement Co., Inc., 236 F.2d 159 (6th Cir., 1956). *cert. den.* 3/11/57.

[11] *Accord Note*, "Thin Capitalization and Tax Avoidance," 55 Columbia Law Rev. 1054 (1955). And see, e.g., Miller Estate, 239 F.2d 729 (9th Cir. 1956), where the court stated "We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt."

[12] The quoted words are from dictum in Kelley, 326 U.S. 521 (1946).

[13] See, e.g., Gooding Amusement Co., *supra;* Dobkin, 15 T.C. 31 (1950).

[14] Miller Estate, *supra;* Kraft Foods Co., 232

what there is to lose by setting up, for example, a 15-year registered debenture bond. Such a bond would pretty clearly be a security so that the incorporation process would be tax free. The client could be restricted to interest payments only; none of the bonds would be retired until the issue had been determined as to whether the bonds created true debt. If they were ultimately recognized, the client would obviously be happy. If they were not recognized, they could then be converted into stock—and nothing would have been lost. While this approach makes sense in general—given a client who is sensible and who has a good memory three or so years from now when the issue arises—the A-B partnership case does seem to face odds not normally encountered by reason of the existence of a negative working capital situation. Whether the clients would want to try a debt structure under these circumstances would have to be ascertained after more thorough discussion.

If the clients were able and were so inclined, the deficit in working capital could be made up by an *additional* loan of $75,000. This would cause the balance sheet to appear as follows:

Current assets	$150,000	Current liabilities	$150,000
Equipment	250,000	Debentures	175,000
		Stock	75,000

The ratio of debt to equity would be 2⅓ to 1, a not excessive ratio if arbitrary standards are accepted. The result would be, of course, the rather peculiar one of a client being induced to buttress the chances of a $100,000 loan being recognized by making an *additional* long-term loan of $75,000. (Help for this situation might come from third-party loans on the assets, discussed *infra*).

If a debt structure is in some fashion attempted, we have seen that no assistance is required to bolster up the ratio of equity to debt. However, it is interesting to speculate for the moment on the availability of additional arguments were they required. One such argument is that the ratio should be measured not in terms of book values but in terms of market values.[14] And one ingredient of market value is good will,[15] of which it happens in the instant case there does not seem to be any at all.[16]

As has already been mentioned, we can have debt associated with either a tax free or taxable transfer. While this question is discussed by Mr. Rosenfeld, *infra*, it does seem reasonable for our purposes to conclude that a tax-free incorporation would be best.

Under such circumstances, the debt structure—if it were ever determined to have any—should most safely be represented by formal long term obligations, either bonds or debentures, registered and/or with interest coupons attached, in order to insure treatment as a security and not as "boot." Of course, so long as the face and fair market values of the stock and debt instruments (as ascertained by the value of the assets and good will transferred) is less than the basis to A and B of such property, so that there is *no gain* in the transaction, a short term obligation could also be issued[17] without fear of being classed as "boot" and causing A and B to be taxed at the fair value thereof. In our case, it would seem either a short or long term obligation could accordingly be issued, ignoring for this purpose the question of ability to repay.

Encumbering assets before transfer

If, as we have seen, creation of a thin corporation through arbitrary division of the excess of assets over liabilities between debt and equity will very possibly not work in the case at hand, we might inquire as to the possibility of encumbering the equipment b e f o r e transfer thereof to the corporation subject to the loan.[18] Obviously, however, this will not readily work in our case because of the same difficulty of projecting an early repayment, and because of the adverse effect on the corporation's credit position which such an encumbrance would have.[19] It might be the only way to finance the negative working capital, however.

Sale to corporation

Let us suppose that B, without a son in the business, would like his estate to share in the business after his death (our statement of facts indicates this), but wishes quite reasonably to leave a minimum amount invested in this manner on his death.[20] His thought is that the excess could be invested in some other medium providing a safer albeit smaller return. Let us further suppose that during B's lifetime, B wishes to place a minimum amount at risk in the business, with which thought A heartily concurs.[21] With these quite reasonable motives in mind, A and B would like to incorporate with as little investment as possible, and to sell some or all of the balance of their partnership assets and liabilities at fair market value, paying a capital gain tax but stepping up the basis of the assets in the hands of the corporation for depreciation and resale purposes. Recent cases indicate that this technique can be applied quite successfully.[22]

However, again, it would seem to have only limited application to the facts with which we are concerned. Thus, if the land and building were sold to the corporation for $250,000 and all remaining assets and liabilities contributed, and if the purchase obligation were payable in 15 years, there would barely be enough projected corporate earnings to make the required payments, pay salaries and taxes, make up the working capital deficit, and at the same time provide a reserve for growth.

Likewise, if the land and building were retained out of the corporation and the remaining assets and liabilities sold to the corporation even on a ten-year purchase basis, the purchase would hardly be feasible, even assuming as much as a $75,000 investment by A and B in the stock of the corporation, and for the reasons indicated.

However, as earlier noted, the possibility of financing the deficit working capital with additional long-term debt obligations (either from A and B, or from third parties) should not be overlooked, since it might make feasible one or more of the above plans. The term

F.2d 118 (2nd Cir. 1956); Perrault, 25 T.C. 439.

[15] Perrault, *supra*. This approach has been used in cases involving sales to corporations, and seems equally applicable to §351 transfers.

[16] The partnership earned $20,000.00 after drawings on average tangible assets of at least $300,000.00. A reasonable return on those assets would leave no earnings attributable to intangibles, i.e., no good will.

[17] Except of course in our case we have seen that such debt cannot be repaid within a short time.

[18] See Bittker, *op. cit. infra*, for distinction between taking property subject to an encumbrance and assuming one from the standpoint of thin corporations.

[19] If we choose to speculate on the encumbering of the land and building, note that if the value thereof be assumed to be $250,000.00 and the loan value thereof $125,000.00, a §357(c) situation would be created upon transfer thereof to the corporation, since the basis of the property is only $100,000.00. A possible solution would be to have A and B transfer their partnership interests to the corporation *after* partial liquidation of the remainder of the assets and liabilities.

[20] Miller Estate, *supra at note* 11, contains these facts, but death was expected momentarily.

[21] Brown, 27 T.C. 27, (1956) contains these facts.

[22] Thus, in Miller Estate, *supra*, stock was issued for $1,050.00, and a purchase of $175,000 was made. In Brown, *supra*, $270,000.00 of stock was issued, and a sale of $605,000.00 was made. And in Perrault, *supra*, $2,000.00 of stock was issued, and the sale was for $973,000.00. Extra contributed values were found over and above book value or sale price in the Perrault and Miller cases. This matter of justifying an ostensibly inadequate stock issue on the ground that extra values were contributed can have dangerous repercussions in the hands of the corporation on the matter of allocation of basis to the assets acquired. The manner in which Perrault decided the question is not only unclear but very unreliable authority on the subject of basis, in the

of these debts need not be, and possibly should not be, the same as that of the purchase obligation, of course.[23]

Guaranteed loans

Some mention should be made of loans by outsiders guaranteed by the interested stockholders. It should be apparent that this device will probably not apply in the instant case, again because of the factual situation and the difficulty of repayment.

Even if workable, the idea has been criticized quite strongly and correctly,[24] and would seem to represent a rather weak prop for a thin capitalization.

Advice where debt structure is created

Notwithstanding the obvious conclusion of the author that debt in the instant case appears more unattainable as a practical goal than as a legal one, the momentum created by partial coverage of the subject forces the effort at completeness. On this account, just a few words of advice might be given respecting those cases where debt structure appears in order:

(i) The debt instruments should have a fixed maturity date, and all payments of principal and interest should be made as required. Where a taxable transfer is sought, the maturity date should be short-term; where a tax-free transfer is desired, the maturity should be long-term.

(ii) Security should be given for the debt.[25]

(iii) Hybrid debt instruments should be assiduously avoided,[26] such as subordinated notes, or notes whose repayment is contingent on earnings.

(iv) All corporate formalities should be observed, such as full and complete minutes, formal issuance of notes, bonds or debentures in registered form with interest coupons attached where appropriate, and building up of a valuable record with the Corporation Commissioner or other "blue sky" agency.

(v) Disproportionate borrowings should be sought if possible, although the persuasiveness of this factor seems to be on the wane.[27]

Conclusion

It is unfortunate that the factual situation of the A-B partnership has given relatively little room for movement in the field of equity and debt financing. On the quite reasonable assumption which has here been made that the land and building will be withheld from the corporation, it would appear reasonably clear that because of the negative working capital situation, debt financing would be recommended to A and B largely on the "what have you got to lose?"—principle.

As to whether a two class stock structure involving common and preferred would be feasible would depend to a large extent upon the gift-mindedness and death-mindedness of A and B. It would also depend upon correlation with other advice which they are to receive from allied counsel to whom we now turn. ☆

author's opinion.

[23] See Miller Estate, *supra*.

[24] See Bittker, *"Thin Capitalization: Some Current Questions,"* 34 Taxes 834-5, (1956). The Commissioner has recently placed in litigation the case where a purported loan was made on the security of U. S. bonds, the loan proceeds being used to finance their purchase. The Commissioner has refused recognition of the *loan made by the bank* on the ground it was not a true loan, and has accordingly disallowed the interest deduction thereon. Autry, Tax Court Docket No. 66455 filed April 4, 1957.

[25] In the Brown case, a conditional sales contract was given; and in the Miller Estate case, a chattel mortgage was given.

[26] See Kelly, 326 U.S. 521 (1946).

[27] Loans by a majority stockholder not proportionate to loans by minority stockholder will constitute an investment where capitalization is clearly inadequate in relation to the projected business, Reed, 242 F.2d 334, (2nd Cir. 1957). Colony Inc., 26 T.C. 30 (1956) held similarly where the loans were made by the minority stockholders. And the Tax Court in Kolkey, 27 T.C. 37 (1956), recently held that advances created an investment where the party advancing held *no* stockholding interest whatever.

Taxable or tax free incorporation: multiple corporations

MR. DONALD ROSENFELD, Los Angeles attorney, reviews briefly the techniques for obtaining a taxable or tax-free incorporation and discusses the factors influencing the choice of method. Then he turns to the possibilities and dangers in the use of multiple corporations. Here are his views:

Going forward with the decision to incorporate the A-B Manufacturing Company partnership involves much more than merely wrapping up the partnership business and transferring its assets, liabilities, receivables and payables to a corporation in exchange for its stock. First of all, it may be preferable not to transfer all the assets of the partnership to the corporation. In order to determine whether all or part of the assets should be transferred, it is necessary to consider the preliminary question whether the incorporation should be set up as a taxable event or as a tax free exchange.[1]

The fair market value of the A-B Manufacturing Company assets exceed book value of $150,000. All or part of this amount can be made subject to tax, depending on which route is selected. If A and B receive less than 80% of the stock of the corporation, at least $150,000 will be taxable as capital gain. To avoid 80% control in A and B, 21% of the stock could be issued, for example, to A's son and other key employees as compensation for their past and future services in the business.[2] Since only A and B would have transferred property and they received less than 80% of the stock, the entire gain would be taxable.[3] If, however, the stock issued to A's son C is in fact a gift from A, and conceivably from B too, it might be held that A and B first constructively received the stock and then transferred it to C. In this event A and B would be deemed to have received the stock for purposes of determining the percentage of stock received by each.[4]

The partners might wish to incur this immediate tax to obtain a higher basis for depreciation of the assets by the corporation. This decision requires an objective appraisal (preferably one by a disinterested appraiser) of what assets account for the excess of market value over book. A higher basis for the land would not benefit the corporation.[5]

After due allowance for salaries to A and B after incorporation, there is no indication of any substantial goodwill because the partnership, before salaries, has made average profits of only $80,000 for three years on a net worth of $300,000. If goodwill did exist, however, it would be subject to tax without benefit of an offsetting depreciating deduction. An immediate tax on goodwill thus can cancel the benefits of a higher basis for depreciation on other tangible assets.

A and B can limit the amount of the gain by taking at least 80% of the stock and by also taking "boot." The amount of the gain would be limited to the amount of the "boot." Since current liabilities of A-B Manufacturing Company exceed current assets it would not be sound to put in and then take out cash. A and B could, however, take short-term unsecured notes as "boot" in exchange for some of their property and pay a tax on the value of the notes but never in excess of the gain.[6] This assumes that the notes will be accepted as true debt and not equity of one form or another. Unintended "boot" could arise if undrawn profits of A and B in the partnership are set up as a credit on the books of the corporation to the draw-

ing accounts of the partners, A and B.[7]

A and B can defer any tax upon incorporation by taking all of the stock and no "boot." Although under the 1954 Code they no longer need each take stock in the same proportions as their interests in the partnership or its assets, they can eliminate troublesome income and gift tax problems if they each take stock in accordance with their proportionate interests. If it becomes necessary, however, for business or personal reasons to issue stock to C or other key employees either as a gift or as compensation for services the gift and income tax consequences should be considered.[8] In no event, however, if the exchange is to be nontaxable, can A and B take less than 80% of the stock unless C or the other employees put up cash or property for their stock.[9]

In place of exchanging assets for stock, A and B might sell some of the assets to the corporation. Some of the machinery and equipment could be sold on a conditional sales contract or by an outright sale for corporate notes. If the sale is made in connection with a Section 351 incorporation the corporate obligation on the conditional sales contract or the notes would be taxable "boot," if gain is realized on the sale.

Selection of assets

Having considered the alternatives of taxable or tax-free incorporation, A and B should next consider what items should be transferred to the corporation. Any assets which they anticipate will soon be sold should not be transferred. Even though the tax rate on a capital gain of the corporation and of the individuals might be the same, if sold by the corporation it would probably be necessary to pay additional tax to remove the proceeds from the corporation.[10]

The current assets should be examined for installment accounts receivable. Generally, a disposition of an installment receivable accelerates the tax on any profit not previously recognized. If the transfer that takes place is a tax free incorporation of the partnership, however, under Section 351 there would probably be no acceleration.[11]

If current assets consist in part of stocks and bonds and it is desired to hold out some of these assets, it would be preferable for the individuals to retain the bonds. Because of the 85% dividend credit, the corporation will pay a tax on the dividends on the stock of only 4.5% to 7.8%, while the bond interest will be taxed as regular income.[12]

A change from one accounting method for the partnership to another for the corporation may influence the handling of partnership receivables and payables. If the change is from accrual to cash, it may be desirable for the individuals to retain the receivables. Otherwise they may be taxed a second time in the corporation on the cash basis upon receipt. If the change is from cash to accrual, however, the tax deductible expenses should be paid by the individuals in order that the deductions not be lost altogether. It may be necessary for the individuals to retain some cash for this purpose as well as funds for contingent personal liabilities and income taxes.[13]

A and B may wish to have the corporation assume their outstanding personal liabilities, such as for past or current income taxes. Section 357(a)(1) permits such an assumption without the recognition of gain or loss and it includes both business and personal liabilities. Care must be exercised, however, that the amount of liabilities assumed plus the amount of any liabilities to which the property transferred is subject do not exceed the basis of the property transferred to the corporation. Any excess of such liabilities over basis might be subject to tax under Section 357(c) either as a capital gain or ordinary income.[14]

A final and important possibility in partial incorporation is for A and B personally to retain certain assets such as the land and buildings which they can rent to the corporation. This is an acceptable method of passing income from the corporation to the individuals for which the corporation may get a deduction. It is essential that the rental be fair; otherwise the Commissioner may treat the rent as in fact a dividend. This procedure would be particularly advantageous in case the land and buildings were sold. If sold personally by A and B there would be only a tax on the capital gain. If sold by the corporation, however, the corporation would have the gain and A and B would not be able to obtain the proceeds from the corporation except at the cost of being taxed on the accumulated earnings and profits of the corporation as a dividend to the full extent thereof up to the amount of the proceeds.

Multiple corporations

Rather than retain any assets individually, A and B may prefer the use of multiple corporations. In case of a sale if the land and buildings were in a separate corporation, it would be possible to pay a tax on the gain and obtain the proceeds without risk that the proceeds might be taxed as a dividend. If the land and buildings were originally put in the same corporation as the

[1] An additional preliminary question is whether the partnership should transfer the assets and then distribute the stock received in exchange or whether the partnership should first be liquidated and the partners transfer the assets. If A or B acquired his interest in the partnership from a predecessor partner, the basis of his partnership interest might be more or less than his share of the basis of the partnership property. If the basis of the assets to the partnership is more than their basis in liquidation to the partners, the partnership should make the transfer; if lower, then the partnership should be liquidated before the transfer.

[2] Deliberate avoidance of control will work. See Day & Zimmerman, Inc., 151 F.2d 517 (3rd Cir., 1945); Avco Mfg. Corp., 25 T.C. 975 (1956).

[3] I.R.C. Section 351. If property is of relatively small value in comparison to the value of the stock, the stock will not be considered as issued for property. See Reg. Sec. 1.351-1(a)(1)(ii).

[4] For a discussion of this problem see Costelloe, "*Incorporation of Unincorporated Enterprise*," 13 N.Y.U. Tax Inst. 685 (1955).

[5] If a husband and wife and their minor children own 80% of the stock, a taxable transfer of depreciable property may be taxed as ordinary income. I.R.C. Sec. 1239.

[6] I.R.C. Sec. 351(b). Stirn, Inc., 107 F.2d 390 (2nd Cir. 1939); Lloyd-Smith, 116 F.2d 642 (2nd Cir. 1941), *cert. den.* 313 U.S. 588; Pinellas Ice & Cold Storage Co., 287 U.S. 462 (1933).

[7] The drawing accounts are not securities. A and B would be taxable to the extent of the drawing accounts. I.R.C. Sec. 354(a)(2); Harrison, 24 T.C. 46 (1955).

[8] See Costelloe, "*Incorporation of Unincorporated Enterprise*." 13 N.Y.U. Tax Inst. 685 (1955).

[9] The amount of the cash or property should come close to the value of the stock. An insignificant amount of cash or property will be disregarded and the stock will not be considered to have been issued for property. Reg. Sec. 1.351-1(a)(1)(ii).

[10] If the assets were to be sold at a loss it would probably be preferable to have the sale made by the individuals to take advantage of the two-year operating loss carryback which would not be available if they were sold by the corporation.

[11] I.R.C. Sec. 453(d). See Portland Oil Co. 109 F.2d 479 (1st Cir. 1940), *cert. den.* 310 U.S. 650. The exceptions to acceleration upon disposition of installment receivables specified in Section 453(d) do not include a Section 351 incorporation, but presumably the Service will continue its practice under the 1939 Code of permitting such an exception. See Reg. 118, Sec. 39.44-5.

[12] Tax free interest on municipal bonds also loses its immunity when it comes out of a corporation as a dividend.

[13] If the corporation continues the cash basis of the individuals, the individuals might again pay the deductible expenses. The corporation would have to capitalize its assumption of the individuals' liabilities and thus would obtain no deduction for such expenses. After the incorporation, if the corporation's bracket is expected to be lower than the individual tax brackets of A and B, the receivables could be transferred to the corporation and thus be taxed at the lower corporate rate.

[14] Section 357(c) is new in the 1954 Internal Revenue Code. Neither the Committee Reports nor the Regulations indicate whether the section should be confined to liabilities related to specific properties or whether it also applies to liabilities unrelated to specific properties, as suggested in the text.

[15] See Reg. Sec. 1.355-1(c)(2), Example (2). If the real estate company has additional income from investments, royalties, or other services, the personal holding company situation should be considered.

[16] Coastal Oil Storage Co., CA-4, 3/11/57.

[17] See Alcorn Wholesale Co., 16 T.C. 75.

[18] Lacking a parent corporation, consolidated returns could not be filed.

[19] Hypotheek Land Co., 200 F.2d 390 (9th Cir. 1952); Twin Oaks Co., 183 F.2d 385 (9th Cir., 1950).

operating business it would be exceedingly dangerous to later attempt to divide the business and remove the land and buildings.[15]

The time to divide the assets between separate corporations is thus at the time of original incorporation wherever possible. This timing is equally important to obtain the benefits of the surtax exemption on the first $25,000 and the $60,000 credit against unreasonable accumulations. Both of these advantages are restricted by Section 1551 in cases of transfers by one corporation to another corporation. The Section does not apply to transfers by individuals to multiple corporations at the outset. This assumes some business purpose for the separate corporations and that they are not mere shells or sham. A business purpose may also be essential under Section 269 upon original incorporation by individuals of multiple corporations if the advantages of the $25,000 surtax exemption and the $60,000 credit are to be obtained.[16] In the subject problem it would seem that the removal of the real estate from liability for the debts of the operating corporation would be an adequate business purpose.[17]

The use of a separate corporation for the land and buildings could also reduce the average rate of corporate tax. If the operating corporation paid a reasonable rent to the real estate corporation, the taxable income of the operating corporation would be reduced accordingly. If we assume that $20,000 a year is a fair rent for the land and buildings based on present market value this would throw $20,000 of income into the real estate corporation which, after deductions for depreciation and expenses, would be taxed at 30%. So long as the amount of the rent in excess of depreciation and expenses reduced profit of the operating corporation at the 52% rate, which in turn would be taxable to the real estate corporation at 30%, a net tax saving would result.

There are also disadvantages to the use of multiple corporations. Losses of the operating corporation could not be offset against profits of the real estate corporation.[18]

The use of multiple corporations which conduct business with each other, will invite the Commissioner's scrutiny under Section 482. Authority is given the Commissioner to apportion and allocate deductions and credits in order to clearly reflect the taxpayer's income. So long as the transactions between the corporations approximate the same terms as would occur at arm's length this Section will not be a problem.[19] This means that the rent must be a fair rent based on the going rent for similar property. There must constantly be considered that if the land company has other income from dividends, interest, or other personal holding company income in excess of 10% of its gross income that the real estate company may be a personal holding company.

Dividing assets between corporations may aggravate estate tax problems when the estate consists chiefly of the corporate stock. Since neither A nor B would own 75% of the stock of both corporations the benefits of Section 303 would not be available unless the stock of one of the companies alone qualified in their respective estates under the 35% to 50% requirements.

Conclusion

Sound tax planning indicates that the land and buildings should be kept separate from the operation of the business. If A and B desire to simply retain this real estate as a personal investment it is perfectly possible for them to do so. However, if they wish to accumulate some income or expand their real estate activities through a separate corporation, the multiple corporation route is also available. There are also additional obvious nontax advantages for title to be in a single corporation rather than divided through inheritance among various members of separate families. ☆

Miscellaneous new decisions this month

Insurance dividend of year's profit accrues at year end. Insurance companies required to include net premiums in income deduct dividends to policyholders; those on the accrual basis deduct accrued dividends. The Service rules that a dividend of the net profit of the company in excess of a fixed dollar amount accrues as of the end of the year. No debt arises upon the declaration because losses may wipe out profit to date. As of the year end, however, all the events have occurred to fix the liability. *Rev. Rul.* 57-134.

Coop can exclude patronage dividends on members' business only. A farmer's nonexempt cooperative marketing crops and selling supplies for members and nonmembers is permitted to treat patronage dividends as an amount excluded from its own gross income. This applies however only to dividends to its members if made in accordance with a pre-existing agreement. Insofar as patronage dividends to members are attributable to dealings with nonmembers, such dividends are taxable to the cooperative and to its members. *Rev. Rul.* 57-59.

Percentage depletion of clay computed on value of brick. The court holds that the precentage-depletion allowance to a clay-mining business is properly based on sales of burnt brick since the brick is the first commercially marketable product. *Harvey*, DC Ariz., 2/21/57.

Oil storage terminal allowed push-back rule. The Tax Court holds that taxpayer proved the increased income it would have had during the base period had it commenced its business as a public deep water terminal two years earlier. The court adjusted taxpayer's computation of its storage tank capacity after two more years of development and construction and allowed a high average use because of the demand for oil storage capacity in New York during the war years. *Tankport Terminals, Inc.*, 28 TC No. 82.

Drought and farm overproduction does not entitle packing company to EPT relief. A corporation canning corn and tomatoes argued that drought conditions in 1936 and farm overproduction in 1937 caused lower earnings during the base period years. The court was not convinced that the drought was an event "unusual and peculiar" in the experience of the corporation, or that the farm overproduction was causally related to the corporation's low base period earnings. EPT relief is denied. *Hougland Packing Co., Inc.*, 28 TC No. 55.

Commercial paper was sold to bank; proceeds not "borrowed capital." Proceeds from promissory notes and conditional sales contracts assigned to a bank do not qualify as "borrowed capital" for excess profits tax purposes; the assignment agreement regarded the transfer of the notes and contracts as an outright sale of the paper involved. *Brizard Co.*, 28 TC No. 133.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

New Tax Court policy seen on "shoestring" purchases of corporations, other redemptions

by STANLEY G. SPRINGER

Recent Tax Court decisions holding that dividends were created as a result of corporate stock redemptions are causing much concern among tax men. The court's unrealistic decisions in Casale, Prunier, Pelton, and Holsey suggest a new policy in deciding these corporate ownership cases. We asked Mr. Springer to comment on Holsey, the latest in the Tax Court's manifestation of this troublesome view. For other news of Casale, see pages 258 and 271.

ATTORNEYS WHO are advising clients concerning the tax effects of so-called "shoe-string purchases" of corporations, or other adjustments in stock control via corporate redemptions, will be somewhat dismayed by the recent decision of the Tax Court in *Joseph R. Holsey*, 28 TC No. 107.

A "shoe-string purchase" is the name commonly given to a transaction whereby the ownership of all the outstanding common stock of a corporation is acquired with a minimum cash outlay on the part of the new owners by purchasing a relatively small number of shares from the retiring stockholders, following which the remainder of the shares owned by the retiring stockholders, are redeemed by the corporation, either for immediate payment in cash or, more commonly, in exchange for installment debt obligations of the corporation.

Other frequently-engaged-in transactions involve redemptions which are designed to change control of the corporation or eliminate dissatisfied groups.

Handled properly, the sale of the stock to the corporation by the retiring stockholders may be treated as a redemption under Section 302 of the 1954 Code (*Zenz v. Quinlivan*, (CA-6, 1954) 213 F.2d 914; *Rev. Rul.* 54-458, CB 1954-2, p. 167; *Rev Rul.* 55-745, CB 1955-2, p. 223) and, where installment debt obligations are given, and less than 30% of the selling price is paid during the taxable year of the sale, the gain may be returned on the installment method under Section 453 of the 1954 Code (*Frank H. Gilbert*, 25 TC 81 (1955), *rev. on other grounds*, (CA-9, 1957) 241 F.2d 491; *Minnie R. Ebner* 25 TC No. 122).

In *Holsey*, the Tax Court charged the holder of 50% of the outstanding stock with a dividend under Section 115 (g) of the 1939 Code when the corporation purchased the other outstanding 50% from another stockholder pursuant to an option which the taxpayer had assigned to the corporation.

The taxpayer argued, unsuccessfully, that he could not be charged with a dividend as the result of the payment made by the corporation to the other stockholder because he had no legal obligation to purchase the stock, but merely an option to do so, and that there was a corporate purpose to be served in making the acquisition, since divided stock ownership was contrary to the policy of the automobile manufacturer for whom the corporation was a franchised dealer.

The Tax Court held that the test to be applied in determining whether a payment by the corporation is substantially equivalent to a dividend to a particular stockholder is a benefit test: "whether or not the payment was for the personal benefit of the stockholder and personal benefits can result to a stockholder in situations other than satisfying his obligations."

As for corporate purpose, the Tax Court held that if problems for the corporation resulted from stock ownership, it was up to the stockholders, and not the corporation, to remedy the situation, saying: "It seems obvious that it would not be the business of a corporation to use its earnings to redistribute its stock amongst shareholders."

The Tax Court expressly refused to follow *Tucker*, (CA-8, 1955), 226 F.2d 177, which found a proper corporate purpose for payments made by a corporate distributorship to accomplish a similar change in stock ownership in obedience to an automobile manufacturer's policy requirements, saying: ". . . it is apparent to us in both instances the payment out of earnings was for the purchase price of stock that was designed to and did increase the stockholdings of the taxpayers in the corporation making the payment."

New Tax Court policy

The *Holsey* decision appears to be a departure from the rules established by a number of prior decisions involving similar readjustments of corporate stock ownership and clearly suggests that, so far as the Tax Court is concerned, to the extent of available earnings and profits, payments made by the corporation to the retiring stockholders in the typical "shoe-string purchase" situation, and in other transactions designed to adjust stock control, may be taxed as dividends to the new owners, regardless of the fact that they have no personal obligation for payment of the purchase price of the stock acquired by the corporation, and notwithstanding that such readjustments of stock ownership serve what has heretofore been considered to be a corporate purpose.

The only element in the *Holsey* case which distinguishes it from prior decisions which reached a contrary result was the existence of a long-term written stock option which had been in the hands of the stockholder for many years and which was revised so as to make it assignable to the corporation, but it is questionable that this should

have had any bearing on determining the taxability of the transaction — in the light of the reasoning of the earlier decisions on the subject.

Older cases contra

Consider how you would have advised Mr. Holsey in the light of the following decisions:

In *Ray Edenfield* (1952), 19 TC 13, *acq.* 1953 IRB No. 13 at p. 1, the sole stockholder, an estate, sought to dispose of its stock without much success, but finally found a group which was willing to come up with a substantial amount of cash (which the estate needed) to acquire 100% ownership of the corporation, which amount, however, was substantially less than the net worth of the corporation. To accomplish the sale, an arrangement was worked out whereby 18% of the stock was sold to the new group at the price which they offered and the remaining 82% was redeemed by the corporation in exchange for mortgage notes.

The Commissioner determined that the payments made by the corporation on the mortgage notes were dividends to the new stockholders, arguing that such payments were in reality payments made on behalf of the purchasing group in order to permit them to acquire the corporation.

The Tax Court reversed this determination on the grounds that the new stockholders had no personal obligation in connection with the notes given by the corporation to the selling stockholder and the payments, therefore, did not satisfy any legal obligation of the stockholders. The Tax Court observed, though it is not clear how much of a bearing this had on its decision, that the evidence indicated that the purchasing group did not participate in planning the arrangement for sale and redemption, but merely accepted the plan as it was offered to them.

In *Fox v. Harrison* (CA-7, 1944), 145 F.2d 521, the holder of two-thirds of the outstanding stock was apparently unhappy and wanted to dissolve the corporation. Taxpayer, the holder of the other one-third of the stock, did not want to do so. The corporation redeemed a portion of the dissatisfied stockholder's stock by cancelling a large indebtedness which he owed to the corporation, but it was unable to raise sufficient funds to redeem the remainder. The taxpayer attempted unsuccessfully to arrange a loan for the corporation and finally borrowed the money personally and purchased the remaining stock, which was later purchased from him by the corporation.

The Commissioner argued that a dividend resulted when the corporation purchased the stock from the taxpayer, but the court found that the taxpayer, in purchasing the stock, was doing so as the agent of the corporation, as a temporary expedient, with the understanding that the corporation would purchase the stock from him when funds became available, and that, therefore, the transaction must be treated as if there had been a direct purchase of all of the stock of the retiring stockholder by the corporation. Treating the transaction in this manner, the court found that no dividend resulted to the remaining stockholder.

In *Fred F. Fischer* (1947), 6 TCM 520, the stock of a minority stockholder was purchased by the corporation in connection with the settlement of litigation to which taxpayer, the beneficial owner of a majority of the stock, and the selling stockholder, were parties.

The Tax Court held that the payment for the stock did not constitute a dividend to taxpayer because the selling stockholder had evidenced dissatisfaction with the management of the corporation [the taxpayer, incidentally, was the principal managing officer], and a corporate purpose was served in buying her out and restoring harmony, any resulting personal benefit to the taxpayer being not of a kind which would justify a holding that any part of the purchase price was a dividend to him.

In *Tucker, supra,* which the Tax Court expressly refused to follow in the *Holsey* decision, the corporation, a Ford distributorship, was threatened with loss of its franchise if taxpayer did not acquire at least 50% of the stock. A minority stockholder agreed to sell to taxpayer at a certain price if the corporation would agree to pay him 20% of its earnings for the next five years.

The Commissioner's determination that the 20% payments were dividends to taxpayer was upheld by the Tax Court, but the circuit court reversed, holding that the payments made by the corporation were primarily for its own benefit and served a business purpose, since the corporation would have lost its franchise as a distributor if taxpayer had been unable to secure at least 50% of the stock.

In a case involving the question of whether there had been an unreasonable accumulation of earnings and profits under old Section 102, a proper corporate business purpose has been found in the use of such surplus to buy out one group of stockholders where that group and the remaining group differed as to whether the corporation should be sold or merged rather than expanded on its own (*Dill Manufacturing Co.,* (1939), 39 BTA 123, where the Board said: "The [corporation] constituted the life work of its operating officers [the remaining group]. They had built it and were proud of it. The protection of the economic and financial independence of that work was scarcely less warranted as a business purpose than if [the corporation] had been an individual.") So also, in the case of a two-family corporation, the use of surplus to buy up the stock of one family rather than have it go on the market with the chance of acquisition by persons who differed in policy with the present owners and might disrupt harmony in the corporation, was held a proper business purpose and Section 102 was not applied. (*Gazette Pub. Co.,* 103 F. Supp. 779 (DCED Ark., 1952); cf. *Pelton Steel Casting Co.,* 28 TC No. 20, appeal pending CA-7.

Moreover the view has been taken by the courts and the Service that an exchange of preferred stock for common stock which is designed to shift control of a corporation to those who are active in its management is a reorganization which serves a corporate purpose (*Elmer W. Hartzel* (1939), 40 BTA 492, *acq.* 1939, 2 CB 16; *Marjorie N. Dean* (1948), 10 TC 19, *acq.* 1949, 1 CB 1; *Rev. Rul.* 55-112, 1955-1 CB 344).

Personal Obligation

The significant feature of the cases where a dividend was charged to a stockholder as the result of payments made by the corporation for the stock of other stockholders has been the personal obligation of the taxpayer in connection with the stock purchase.

For example, in *Wall* (CA-4, 1947), 164 F.2d 464, taxpayer, the holder of 50% of the stock, agreed to buy out the holder of the remaining 50% and gave his personal notes for the price, the stock being held in trust pending payment. Taxpayer later transferred his

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equity in the stock to the corporation in exchange for its agreement to pay the notes as they fell due. The court held that the payments by the corporation were dividends to taxpayer because they satisfied his personal legal obligation to pay the notes.

In answer to Wall's argument that the transactions should be treated as if the corporation had purchased the stock directly from the retiring stockholder, the court observed that the transaction had not in fact been handled in that manner, that if it had been there would have been no personal obligation on taxpayer's part, and that "it is precisely the payment of that obligation by [the corporation] which constitutes income to [taxpayer]."

In *Lowenthal* (CA-7, 1948), 169 F.2d 694, the taxpayer and his associates drew funds from the corporation on open account to purchase the stock of the remaining stockholder and later surrendered the stock so acquired to the corporation in cancellation of the debts. The court held that the surrender in cancellation of the debts was a dividend, since there was no change in the proportionate interests of the stockholders involved and that there was no evidence to support the contention that the stockholders purchased the stock as agents for the corporation, thus distinguishing the facts from those in *Fox* v. *Harrison, supra*. There is at least an inference, therefore, that the stockholders might have escaped taxation if the corporation had purchased the stock directly.

Conclusion

If *stare decisis* is to have any meaning in the Tax Court, non-dividend treatment to the new or remaining stockholders seems indicated in view of the above decisions, the importance placed upon the question of whether the payment satisfied a personal obligation of the stockholder, and the ease with which the courts had found corporate business purposes to be served by readjustments in stock ownership and control. In view of the clear rationale of the prior cases, it is not surprising that one writer, after discussing the argument that "shoe-string purchases" involving redemptions with debt obligations of the corporation are virtually indistinguishable economically from the *Wall* situation, and represent a more logical case for dividend treatment to the new stockholders than similar redemptions where surplus is used and the entire price paid in cash, concluded: "Despite these arguments, the point now seems well established that in the absence of a direct personal obligation by the buyer, distribution by the corporation in redemption of the seller's shares will not constitute a dividend to the buyer under Section 115 (g)." (9 *Tax Law Review* 354, 357 (1954)).

While the tax effects of stock redemptions on the selling stockholders in transactions of the nature under discussion has been, if not materially changed, at least codified, by Section 302 of the 1954 Code, particularly the "complete redemption" provisions of Section 302(b)(3), the tax effects on the remaining or new stockholders continues to be governed by the same general provision under the 1954 Code as it was under the prior law—and that is whether the distribution by the corporation is substantially equivalent to a dividend to them (Section 302(b)(1)). The Service has given warning that it is going to examine transactions of this nature carefully to determine whether the redemption has the effect of a dividend to the remaining stockholders. (*Rev. Rul.* 54-458, CB 1954-2, p. 167; *Rev. Rul.* 55-745, CB 1955-2, p. 223).

All in all, the writer feels that Mr. Holsey may have been the unfortunate victim of a reversal of policy on the part of the Tax Court and that, unless the *Holsey* case is appealed and reversed, taxpayers had better be prepared to demonstrate, before the Tax Court at least, a much stronger business purpose for such redemptions than has heretofore been required, and incoming or continuing stockholders should avoid becoming personally involved in the arrangements between the corporation and the selling group. ☆

Casale reversal clarifies relation between stockholder and controlled corporation

STOCKHOLDERS of closely held companies, tax advisors and insurance men enthusiastically welcomed the recent decision of the U. S. Court of Appeals for the Second Circuit reversing the Tax Court's *Casale* decision (CA-2, 9/5/57, *rev'g* 26 TC 131). The planning department this month contains a full analysis of this case (see page 258) and we have only a few words to say about it here.

When the Tax Court disregarded the corporate entity and taxed the controlling shareholder for constructive dividends for the amount of the premiums on life insurance on his life, even though the policy was owned by and made payable to the corporation, tax and insurance men throughout the nation shuddered. *Casale* was followed in short order by *Prunier* and *Sanders*, which cast an even darker cloud over the whole field of insurance in connection with retirement and deferred compensation plans as well as with buy-and-sell stock agreements.

Some authorities argued that *Casale* was an extreme or unique case in that Mr. Casale was a 98% shareholder and moreover, the deferred compensation agreement and the purchase by the corporation of the funding life insurance policy were not only simultaneous but were even authorized in the same corporate resolutions. These factors undoubtedly influenced the Tax Court in arriving at its disturbing conclusion that the corporation was a "mere conduit between taxpayer and the insurer" and the whole transaction was a "sham for tax purposes."

The Second Circuit, in reversing and refusing to sustain the taxability of the premiums as dividends to Casale, plainly felt that the similarity between the agreement and the insurance policy was not significant. This feature indicated only that Casale "controlled the corporation, not that he *is* the corporation."

Of compelling importance was the court's refusal to accept the Tax Court's finding of sham and that the corporation was merely a conduit. The only basis for the lower court's finding was that petitioner was controlling shareholder, but such a theory would apply equally to every corporation having one or more controlling shareholders. "This argument thus encompasses all corporations which are dominated by one or more controlling shareholders."

The Court of Appeals took a realistic view in holding that the policy was owned by the corporation and was truly a corporate asset. "In any event, there is no warrant for calling the benefit 'immediate,' for at best it was only tentative. Despite the Commissioner's efforts

to show the illusory nature of the forfeiture conditions of the contract (e.g., voluntarily leaving the corporation's employ against the wishes of the corporation) we believe that the corporation's insolvency would have terminated forever taxpayer's interest in the policy (if, indeed, he ever had any interest). . . ."

". . . The policy is a corporate asset in every sense of the word: as the Tax Court found, the corporation paid the premiums and 'possessed the right to assign the policy; the right to change its beneficiary; the right to receive dividends as declared by the insurer; and the right to borrow on the policy in an amount not exceeding its loan value.' In the event of insolvency, corporate creditors would be able to reach the policy as they might any other asset. *Lincoln Nat. Life Ins. Co.*, 62 F.2d 582, (5th Cir.). Taxpayer would at most have an unsecured claim under this contract and would share pro rata or he might even be subordinated to the claims of other creditors. See *Pepper* v. *Litton*, 308 U. S. 295."

One particularly interesting and significant feature was stressed. If Casale died between the 9th and 13th year of the policy, the corporation would have received an amount well in excess of $50,000, but it could carry out its contractual obligation to the taxpayer for $50,000. Here was additional demonstration that taxpayer did not own the policy.

This feature is typical of many deferred compensation plans where insurance *may* be used to carry out the corporate obligation to pay the deferred compensation benefits. Frequently the tax-free death benefits receivable by the corporation will exceed substantially the obligation the corporation may have to the family or other beneficiaries of the employee. Of equal significance is the fact that there is no need or requirement that the death benefits or the retirement benefits be paid out of the insurance proceeds or cash surrender value. The company may prefer for good business reasons to make these contractual payments out of current and future earnings, particularly where the employee or widow is to receive such payments in installments over a period of years. In a sense the insurance policy is similar to any corporate reserve, which may be used, if advantageous, to carry out a specific purpose, but which is available for all other corporate purposes and obligations.

The Court of Appeals was keenly aware of the real situation when it commented: "At most, the policy indicated to the taxpayer what method the corporation had chosen to enable it to live up to the contract obligation. The policy itself did not inure to the taxpayer's benefit nor was it earmarked for him. If business warranted, taxpayer's monthly retirement payments could have been made from general cash or a special reserve fund. The economic benefit to taxpayer was not in the form of a $50,000 life insurance estate, as such, but rather in another new corporate asset upon which he or his executor might levy if the corporation should default on its contractual obligation."

The reversal of the *Casale* case carries out a pattern established in *Emeloid Co.* (CA-3, 1951), 189 F.2d 230, where the Third Circuit reversed the Tax Court, and held that there was a business purpose for insurance purchased by a corporation for the purpose of permitting the purchase of stock of any deceased stockholder. The Court of Appeals properly observed that key-man insurance served a very important business purpose, commenting: "What corporate purpose could be considered more essential than key-man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets—managerial skill and experience. In fact, the Government has not seriously contended here that key-man insurance is not a proper corporate purpose."

We think a note of caution is indicated. While the Second Circuit has adopted a very realistic and businesslike approach to the problem, we have not yet reached the point of unrestrained enthusiasm. The *Sanders* and *Prunier* decisions still stand so far unreversed, although it is not clear what restraining effect the *Casale* reversal may have on those cases. (We understand that both of these decisions are on appeal.) Moreover, while the "sham transaction" and "corporate conduit" theories have been rejected, the Commissioner may continue his frontal attacks on the use of insurance in funding stock and deferred compensation agreements in the case of closely held corporations, particularly where the key employee-shareholder has the slightest element of control or incident of ownership in the policy itself [e.g., right to change the beneficiary]. Meanwhile, it is evident that all new plans in which insurance is indicated should be very carefully drawn, and only after a comprehensive study of the *Casale*, *Prunier* and *Sanders* opinions.

One further note of caution is indicated before *Casale* is laid back on our shelves of historical tax decisions. We have heard of insurance arrangements where, in lieu of the direct ownership of the policy by the company as in *Casale*, the policy is assigned to a trustee to carry out the deferred compensation plan. We think a substantial risk could be incurred in this arrangement since the cloak of the Second Circuit's concepts in *Casale* may not cover it. No longer could it be urged that the policy is owned by the company and subject to the claims of its creditors, hence even the Second Circuit might agree with the Commissioner that in that situation the employee would have secured an immediate and taxable interest.

New corporate decisions this month

No interest deduction on notes for stockholders' assets; not "borrowed capital." Two equal partners transferred their partnership assets on 12/1/46 to a corporation which they owned in return for two 5% notes of $50,000 each, payable over five years. The notes were not actually executed until 5/31/51 and were then made payable "on demand with six months notice" at 4% interest. The court concludes no debtor-creditor relationship was intended nor had been established with respect to the notes. As a consequence interest paid on the notes during 1951 was not deductible, and the notes could not be included in "borrowed capital" in the computation of the excess profits tax. *Canton Tool Manufacturing Co.*, TCM 1957-161.

Accommodation advances to controlled corporation are non-business. Taxpayers were the stockholders, directors, and officers of a corporation to which they made short-term advances, never repaid because of bankruptcy. Although it was shown that over a 10-year period taxpayers, in varying combinations and groups, actively looked for investment opportunities, the Tax Court found they

were not in the business of promoting, organizing and financing business ventures. The advances which became worthless could only be taken as nonbusiness bad debts—*i.e.*, a short-term capital loss. Similar treatment given to payments made by one taxpayer because of his liability as endorser of the corporation's note. This court affirms. *Towers*, CA-2, 8/2/57.

Dividend on redemption of part of stock; purpose was individual, not corporate benefit. Taxpayer owned half of the stock of two auto dealerships and one third of another. Another stockholder who had held equal interests had transferred part of his shares to family trusts. The manufacturer adopted a policy of denying dealerships to corporations having trusts as stockholders. It was decided therefore that the corporations would redeem some of the shares held by the trusts, and the grantor would buy the rest. Finally, the corporations would redeem enough shares of other stockholders to restore the original proportionate interests. The Tax Court held that the redemption from the individuals was a dividend. The purpose was the advantage of the individuals, not the corporation. This court affirms. *Phelps*, CA-9, 7/24/57.

Assets withdrawn from corporation by stock seller not dividends. Taxpayer agreed to sell all the stock of his corporation for a price to be determined by an audit as of April 30. The buyers assumed management and control on April 30 and the auditor submitted his report on June 1. During May, taxpayer withdrew certain insurance policies, accounts and notes receivable and cash from the business. The district court held these withdrawals represented dividends to the taxpayer. This court reverses. The buyers became the beneficial owners after April 30. Assets withdrawn by the taxpayer represented part of the purchase price. *Mayer*, CA-5, 8/13/57.

Buyout of co-stockholder by corporation a dividend to remaining stockholder. Taxpayer, a 50% stockholder had since 1946 held an option to purchase the remaining shares of an auto sales company from the other stockholder. He assigned the option in 1951 to the company which immediately exercised it and paid $80,000 for the stock. Taxpayer argued that the exercise of the option served a business purpose since the auto manufacturer opposed the divided stock ownership in the dealership. The court holds, however, that the payment by the corporation out of earnings was made at such time and in such manner as to be essentially equivalent to the distribution of a dividend. The net effect of the purchase was to give taxpayer complete stock ownership for his personal benefit. [See comment on page 269. *Ed.*] *Holsey*, 28 TC No. 107.

Expenses not a corporate expense; dividend to stockholder. A corporation made certain expenditures in connection with designing, constructing, and racing of speed boats. Prior to the years in controversy, such activities were purely the hobby of its sole stockholder, while the business of the corporation consisted of owning and renting a building. The court finds that the corporation did not enter into a true business venture of exploiting these racing boats for profit; that its activities were a continuation of the shareholder's hobby for his personal pleasure and satisfaction; that it contemplated merely the possibility of entering into a commercial venture at some future time which never did eventuate. The court therefore holds the expenditures were not deductible by the corporation but were properly includible in its stockholder's income as taxable dividends. *American Properties, Inc.*, 28 TC No. 127.

Premium paid to fund controlling stockholder's retirement agreement not a dividend to him. In order to fund a retirement pension agreement with its president and principal stockholder, a corporation took out a combined life-annuity contract to mature at age 65. The corporation was declared to be the owner of the policy, but the officer, by agreement with the corporation, was given the right to designate the beneficiaries in the event of his death. The Tax Court held that the annual premium of $6,000 paid by the corporation represented a distribution equivalent to a taxable dividend. This court reverses. The stockholder received no immediate benefit, if any benefit at all, from the insurance contract and it was subject to possible claims by corporate creditors. [See comments on page 258 and 271.—*Ed.*] *Casale*, CA-2, 9/5/57.

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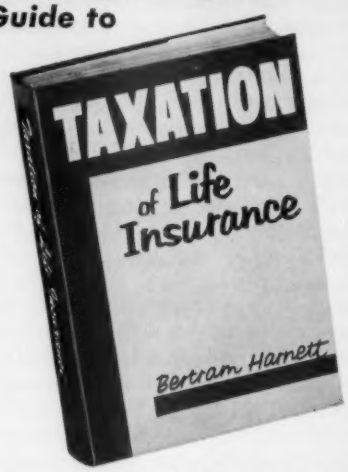

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Swap of "property of like kind" by two companies tax free. A parent telephone company caused one of its subsidiaries to exchange all of its operating assets for all of the similar assets of another telephone company and cash to equalize the value of the assets. The Service rules that the exchange is of property of like kind and gain will be recognized only to the extent of cash received. The ruling calls attention, without comment, to a case and a ruling involving the allocation of the sales price of a going business sold as a unit to each asset. *Rev. Rul.* 57-365.

Subsidiary can deduct interest and service charges paid to parent. Taxpayer here had paid interest and service charges to its parent corporation in years it filed separate returns. The deduction was disallowed by the Commissioner under the authority of 1939 Code Section 45, relating to allocation of income and deductions among related taxpayers. The court overrules the Commissioner, holding that the charges were those which would have been made between unrelated enterprises dealing at arm's length and as such the amounts were reasonable and the purpose justified. *Seaboard Commercial Corp.*, 28 TC No. 119.

Corporation may be collapsible if it distributes FHA windfall. A distribution by a corporation of the excess of its FHA-insured mortgage loan over the cost of construction is a dividend under the 1939 Code to the extent of the available earnings and profits. Any excess reduces the basis of the stock and anything remaining after that is taxed as capital gain. However, distributions made after 12/31/49, the effective date of the collapsible corporation section, will be taken into consideration under both the 1939 and 1954 Codes in determining whether the corporation constitutes a collapsible corporation. (The 1954 Code specifically prescribes dividend treatment for distributions after 6/22/54). *Rev. Rul.* 57-357.

FHA "windfall" profits capital (Old Law) [*Acquiescence*]. This headlined case has an interesting sidepoint regarding capital gain and ordinary income. The taxpayers were stockholders of several corporations organized to build and operate housing projects financed by FHA-insured mortgages. The mortgages on the property were greater than the actual cost of construction. The stockholders received a cash distribution of the difference between the loan and construction cost. The Tax Court held that the distribution was to be applied against the basis of the stock and any excess was taxable as capital gain. The Tax Court was affirmed on appeal, 236 F.2d 612. [Section 312(j) of the 1954 Code closes this loophole for distributions made after June 22, 1954, by treating the proceeds of U. S.-insured loans as "earnings and profits" to the extent they exceed the basis of the property mortgaged.—*Ed.*] *Gross*, 23 TC 756, *acq.* IRB 1957-33.

A method of allocating consolidated income tax liability outlined. For the purpose of determining accumulated earnings and profits the Code prescribes three methods of allocating consolidated income tax among the group. Any other method approved by the Treasury may be used. The method must be elected in the group's first return. The IRS now rules that it will approve a method whereby members of an affiliated group of corporations engaged in different types of operations allocate the consolidated income tax liability in the following way: (1) the consolidated income tax liability is first apportioned to each operational group in the ratio which the operational group's taxable income bears to the consolidated income; (2) the tax liability so apportioned is then allocated to each member of the operational group by the ratio of each member's taxable income to that of the group; (3) any foreign income taxes paid by a member is then applied in reduction of such allocated amount. *Rev. Rul.* 57-392.

Each property separate business for partial liquidation; actual shares redeemed ignored. The IRS rules that each of two properties owned and operated by a real estate corporation (it owned three in all), having been held for more than five years, qualified as a separate business and the distribution of one to the stockholders qualifies as a partial liquidation. In computing the stockholders' capital gain the actual number of shares redeemed is to be ignored. The number of shares so redeemed shall be deemed to be the same proportion of total shares outstanding as the value of the property distributed was of all the property of the corporation. *Rev. Rul.* 57-334.

Subsidiary's distribution to parent insufficient to satisfy preferred stock; loss on common recognized [*Nonacquiescence*]. Taxpayer-corporation, in liquidating its wholly owned subsidiary, received assets insufficient to meet the liquidation rights of the preferred. It claimed a loss on the common despite the provision of 1939 Code Section 112(b)(6) denying gain or loss on liquidation of a subsidiary (same as 1954 Code Section 332). The court agreed. The nonrecognition provisions on the liquidation of a subsidiary will apply only when there is a distribution in liquidation of the common or voting stock. Here the preferred stock claims captured all the assets and there was nothing left to distribute to the parent as a common stockholder in the subsidiary. Two judges dissenting see no authority in the Code for giving special treatment when preferred is involved. This is a liquidation of a wholly owned subsidiary; loss should be disallowed. *Spaulding Bakeries, Inc.*, 27 TC 684, *nonacq.* IRB 1957-32.

Advances upon incorporation were equity investment. Advances of some $144,000 by the incorporator to his thinly capitalized corporation are held to be a capital investment rather than a loan. Repayment was wholly contingent upon the corporate net income and there was no definite obligation to pay a fixed sum at a fixed maturity date. Worthlessness of the investment is held to have occurred in 1950 when the corporation was adjudicated a bankrupt rather than in 1949 when the bankruptcy court ordered a sale of the assets as part of a reorganization plan. The loss on worthlessness is on a worthless security (capital), not a bad debt. *Polizzi*, TCM 1957-159.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

Well-drawn will prevents common disaster from nullifying marital deduction

by **DAVID STOCK**

No estate-planning job is complete unless the will provides for the proper use (or non-use) of the marital deduction. If the testator and his spouse should meet a common disaster marital-deduction plans are often nullified. This tax problem must be considered carefully in choosing among the various standard common disaster clauses. Mr. Stock considers the common and statutory law on the subject, analyzes typical clauses and makes suggestions for their use in various cases, all with consideration of the tax aspect of each solution.

THE GREAT INCREASE in concern about common disaster has considerable justification, even though the motivating circumstance is usually the wrong one. Mr. Testator, who for several years has neglected the making of any will, or a required new one, communicates with his lawyer on a Thursday afternoon and says he wants a will before the following Tuesday, when he is flying to Europe with his wife, thinking about the risk that both of them might be killed in an airplane accident. He and his wife have been exposing themselves to the much less remote hazard of death on the highways, and may very well do so over the intervening week-end, but only the dramatic and vivid impact of the possibility of an airplane accident finally serves to overcome his inertia about a will. He not only wants a will, quickly, but he wants the will to give him the tax advantage of the marital deduction in the event of a common disaster. There have been no children of the marriage between him and his wife, but he has children of a prior marriage.

The problem

In his discussion with his lawyer, in which the common disaster aspect seems to haunt him, he learns that in the event of a common disaster, (1) his wife might survive him momentarily but not long enough to enjoy and make disposition of the property he wants to leave her, and that the property instead of going to his children will, Heaven forbid, go to his mother-in-law and an estranged sister-in-law; (2) destructive litigation may very well ensue between his executor and his wife's family as to whether he or his wife was the survivor, and (3) in the event of his wife's temporary survival, there will be multiple estate and inheritance taxes and administration expenses.

Although we shall be concerned mainly with methods of attempting to insure a marital deduction in the event of simultaneous deaths or temporary survivorship, it should be noted that, in many cases, while a marital deduction may provide a practical advantage in the event of protracted survivorship by the wife, it would be disadvantageous in the event of simultaneous deaths or a short survivorship. Thus, even where the wife has a substantial estate of her own and the simple arithmetic shows a higher aggregate of taxes if a marital deduction is assumed, the advantage of a marital deduction may be substantial if a surviving wife will have the use of the tax saving on the first estate. If the wife is relatively young so that there is the probability of long survivorship, the accretion of income on the taxes saved in the husband's estate and the possibility of reduction of the marital portion by gifts and consumption of principal of marital property by the wife so as to reduce sufficiently the ultimate estate tax on her estate, may indicate the practical advantage of seeking the marital deduction. Accordingly, the marital deduction may be desired where there will be relatively long survivorship of the wife, but will be disadvantageous in the event of simultaneous deaths or temporary survivorship, such as would arise from common disaster.

Before going into the question of what, if anything, the lawyer should put in Mr. Testator's will, to obviate the possible results of a common disaster that are worrying him, let's see what the law provides with respect to common disasters, in the absence of a provision in the will.

The uniform simultaneous death act

At common law, it has been the general rule in most states that where two or more persons perish simultaneously there is no presumption as to survivorship, regardless of the difference in age, sex or physical strength, and the burden of proving survivorship of any such person is upon the one asserting it.[1] Where there is no evidence as to which one died first, the courts will dispose of property rights as though the deaths occurred at the same time—neither person being entitled to share in the estate of the other.[2] Such simultaneous deaths of joint tenants or of tenants by the entireties terminate such tenancy and convert it into a tenancy in common, with an equal share passing as the property of each tenant.[3] Likewise, upon such simultaneous deaths of an insured under a life insurance policy and the beneficiary thereunder, the estate of the beneficiary is not entitled to the insurance proceeds.[4]

The Uniform Simultaneous Death Act, which has been adopted by forty-one states and Alaska and Hawaii,[5] codifies and clarifies the common law rule in the foregoing categories. The general rule is stated as follows in Section 1 of said Act: "Where the title to

[1] Morgan v. Sackett, 16 N.Y.S.2d 583; Masonic Temple Association of Atlantic City, 120 N. J. Eq. 183; Schaefer v. Holmes, 277 Mass. 468; Baldus v. Jeremias, 296 Pa. 313; *In re* Metzger's Estate, 140 Ohio St. 50; 25 Corpus Juris Secundum, page 1069; Wigmore on Evidence #2532.
[2] Modern Woodmen of America, 335 Ill. 239; *In re* Strong's Will, 12 N.Y.S.2d 544; *In re* Kimmey's Estate, 326 Pa. 33.
[3] *In re* Estate of Markiewicz, 71 Ohio L. Abs. 143, 129 N.E.2d 328; McGhee v. Henry (Tenn.), 234 S.W. 509, 18 A.L.R. 103.
[4] *In re* Macklin's Will, 30 N.Y.S.2d 706; *In re* Smith's Estate, 168 N.Y.S. 588; Baldus v. Jeremias, *supra* Modern Woodmen of America, *supra*.
[5] Uniform Laws Annotated, Vol. 9A, page 263.
[6] Cramer v. Browne, 159 Kan. 423; Blanche L. Steele, Mont., Billings Div., Dec. 1, 1956.
[7] Allen C. Street Estate, 25 TC 673; Kasper v.

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property or the devolution thereof depends upon priority of death and there is no sufficient evidence that the persons have died otherwise than simultaneously, the property of each person shall be disposed of as if he had survived, except as provided otherwise in this act."

The Uniform Simultaneous Death Act expressly does not apply "in the case of wills, living trusts, deeds, or contracts of insurance wherein provision has been made for distribution of property different from the provisions of this act," nor to the distribution of the property of a person who has died before the Act takes effect in the particular state which has adopted it. The Act, as adopted in New York and Massachusetts, contains the additional provision that it does not apply to the distribution of property under an instrument, other than a will, executed before the Act took effect.

Assuming that the foregoing common law or statutory rule is in effect in the state in which Mr. Testator is domiciled, his lawyer will understand that, in effect, it provides a presumption of Mr. Testator's survival only in the event that the deaths are really simultaneous, and that the rule will not meet the situation that concerns Mr. Testator if there should be evidence of even a brief survival by his wife.

Thus, while the law will rule out the survival of Mrs. Testator in the event of really simultaneous deaths, the lawyer has the problem of taking care of the contingency of some survival by her. What kind of provisions have lawyers been using under such circumstances and what clauses should be used? It is probably safe to say that, in such situations, most lawyers have used in wills one of the following clauses, or slight variations thereof, with the proviso that in the event of the deaths of Mr. Testator and his wife under the circumstances set forth in said clause, the wife should be deemed to have predeceased Mr. Testator: (1) under such circumstances that it is difficult to determine who died first; (2) if living at the time of distribution of my estate; (3) as a result of a common disaster (hereinafter referred to as the 'common disaster clause'), and (4) if my said wife shall not survive me for at least .... months (hereinafter referred to as the time clause).

The first of the above clauses is unsatisfactory because it itself presents a litagable question as to whether "it is difficult to determine who died first." In any event, it does not seem dependably to go beyond the operation of the Uniform Simultaneous Death Act. The second of the above clauses is also unsatisfactory, because of the danger that a court will interpret it to require merely any survivorship by the wife[6]—which gives no aid to the question of temporary survivorship. On the other hand, if the clause is held to require survival until distribution of the estate, the bequest will not qualify for the marital deduction.[7]

As for the other types of clauses, an attempt will now be made to evaluate these, as well as other methods that are available, from the standpoint of qualifying for a marital deduction and also where a marital deduction is not desired or is not a consideration. For convenience, this discussion refers to the husband's will and the wife's survivorship, but the same considerations will be applicable to a wife's will and, aside from the marital deduction considerations, to a testator or testatrix and any beneficiary who is not his or her spouse.

The common disaster clause

In the first place, and assuming that the marital deduction is not involved, the common disaster clause presents a serious risk to its purpose. Suppose the wife, who has a weak heart or some other organic deficiency, survives the common accident for a rather protracted period and then dies. The difficult question that may be presented is whether her death was due to her pre-existing condition or was induced by the accident. The husband's estate may be involved in litigation, with the risk of diversion of his estate to persons whom he did not wish to benefit, in the event that it should be decided that she did not die as the result of the accident.

In the second place, if the marital deduction is desired, it will be lost if the estate cannot prove that the wife did not die as the result of the common disaster. Under the Internal Revenue Code,[8] the mere fact that the passing of a decedent's interest to a spouse is conditioned upon her not dying as the result of a common disaster involving both spouses or within any period not exceeding six months after the decedent's death, will not disqualify the interest as a terminable one if the spouse does not in fact die as the result of such a disaster or within such period.

Furthermore, if the wife should still be living at the time of the audit of the Federal estate tax return of her husband and it is still possible that she may die as a result of the common disaster, the marital deduction will not be allowed[8] and, if she continues to live sufficiently long after the audit of her husband's estate tax return, it may be too late to obtain a refund of the estate tax—with the possibility of no credit in her estate for property previously taxed, because if she should not die as a result of the accident, the bequest to her will have qualified for the marital deduction in her husband's estate, even though it was unavailable as a matter of procedure.

The time clause

Where the marital deduction is not involved, the time clause is clearly the best type of clause, if any such clause is to be used at all, because by providing a definite required period of survivorship it eliminates the uncertainties as to survivorship or cause of death. To the extent that it serves better to insure against the consequences of temporary survivorship, it avoids litigation, possible diversion of the testator's property, and multiple estate taxes and administration expenses. In New York, this type of clause may present something of a problem, because under the rule against suspension of alienation in that state there is no gross period of years during which vesting may be deferred, and such clause, together with other dispositive provisions, might violate the New York rule, especially where the time clause is made to apply to several beneficiaries.

Incidentally, where residuary bequests are made subject to divestment by such a clause, or any other type of common disaster or survivorship clause, a specific gift over should be provided so that the lapsed legacy, or a portion thereof, may not pass by intestacy to the same beneficiary whose legacy was divested.

Kellar, 217 F.2d 744, IRC Section 2056(b)(1).

[8] IRC Section 2056(b)(3); Reg. 105, Section 8147 (b)(d); Estate Tax Regulations, Section 20.2056 (b)(3). IRC Section 2056(b)(3) provides as follows: "*Interest of spouse conditional on survival for limited period.*—For purposes of this subsection, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if —(A) such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event; and (B) such termination or failure does not in fact occur."

[9] Reg. 105, Section 8147 a-(a); Estate Tax Regulations, Section 20.2056(e)-2(e).

WHEN TO USE COMMON DISASTER AND TIME CLAUSES

THE ESSENCE of when to use a common disaster clause may be summed up in the following six points:

1. Where there is a trust for the wife and the trust is not to qualify for the marital deduction, it is not necessary or advisable to use any type of common disaster, survivorship or time clause.

2. Where life insurance is left on an appropriate option for the wife, with provision for contingent beneficiaries, and the insurance is not to quality for the marital deduction, it is not necessary or advisable to use any type of common disaster, survivorship or time clause.

3. If it is desired to qualify a trust or life insurance for the marital deduction, use only a clause to the effect that in the event of simultaneous deaths the wife shall be deemed to have survived the husband.

4. Where there is outright distribution under a will or insurance policy, a proper will by the wife is all that is necessary with the addition, where the marital deduction is desired, of a clause providing presumption of survivorship of the wife if the deaths are simultaneous. A time clause will furnish some protection against diversion of the wife during the specified survivorship period, and may avoid double administration expenses, but should not be used where the marital deducton is wanted.

5. Where the marital deduction is sought, do not in any will or insurance policy use any common disaster, survivorship or time clause other than a clause providing that in the event of simultaneous deaths the wife shall be deemed to survive the husband.

6. In any case where the marital deduction is not a consideration, no clause other than a time clause should be used.

Where, however, a marital deduction is desired, the death of the wife within a period specified by a time clause will result in the loss of the marital deduction. Furthermore, whether or not the marital deduction is involved, the time clause may not meet Mr. Testator's concern about diversion of his property to members of his wife's family, because she might survive a relatively short time beyond the specified time. If the time clause were the only indicated method whereby the undesirable consequences of temporary survivorship could be obviated or minimized, it would become a question of weighing its advantages against the risk of the loss of the marital deduction. Fortunately, however, there are the following available means of accomplishing both purposes.

A trust for the spouse

A testamentary trust for the wife, with such remainders and substitutional gifts as the husband desires, will of course eliminate all of the foregoing problems. Of course, if it is desired to qualify the trust for the marital deduction, it will be necessary to give the wife a general power of appointment over the principal of the trust. In that case, the husband's will should provide that, in the event there is no sufficient evidence that the husband and wife have died otherwise than simultaneously, the wife shall be deemed to have survived—thus reversing the presumption in the Uniform Simultaneous Death Act. This presumption of survivorship will be given effect, for the purpose of allowing the marital deduction, if the order of deaths cannot be established by proof and the presumption clause is given effect in the probate court.[9] Unfortunately, where there is evidence that the wife actually predeceased her husband, there is no magical clause that will preserve the marital deduction. In the husband's will, the power of appointment granted to the wife should be made exercisable only by a specific reference thereto, to avoid the risk of the residuary clause in her will operating as an inadvertent exercise thereof.

Outright distribution to wife

Suppose that the husband wishes to make an outright distribution to his wife. In that case he probably will have sufficient confidence that his wife will not, by her will, divert the property to others. The remaining problem of possible litigation between his estate and her family, over the question of survivorship, may, it seems, be met easily enough by seeing to it that she has a proper will so that even if she should survive her husband, either briefly or for an extended period, the end result will be the one desired. Here again, if the marital deduction is desired, there should be a clause in the husband's will providing a presumption of survivorship of the wife in the event of simultaneous deaths. If a marital deduction is not desired, a time clause will prevent diversion by the wife during the required survivorship period. However, if the husband is motivated primarily by concern that the wife will be induced to change her will, if she survives the required period, then a trust would seem to be the only answer.

Life insurance

All of the considerations hereinabove set forth with respect to wills apply as well to life insurance. Where a marital deduction is not involved, a time clause may and should be used, which in effect designates the wife to receive the insurance proceeds if she survives her insured husband by a specified period, or, if she does not, then the proceeds are to go to a designated contingency beneficiary. However, where a marital deduction is desired, even in the event of simultaneous deaths, a presumption clause may and should be used to the effect that the wife shall be deemed to have survived.

Where the husband fears diversion of the insurance proceeds to others, he can channel the insurance proceeds into an insurance trust, or place the insurance on an installment option or on the interest option, with or without limited or deferred rights to the wife to withdraw principal, with appropriate provisions in either instance for contingent beneficiaries — and with a proper power of appointment to the wife, in any case, if the marital deduction is desired. ☆

New estate & gift decisions this month

Jury upholds estate's valuation. In a jury trial, it is for the jury to determine the fair market value of real property for estate tax purposes. The burden of proof is on the taxpayer to show that the Commissioner erred in fixing a value higher than that contended for by the taxpayer. The term "fair market value" means the price at which the property in question would change hands between a willing buyer and a willing seller, both in possession of all of the

relevant facts. These points were made in the trial judge's charge to the jury in the present case, the jury then returning a verdict sustaining the taxpayer's valuation. *O'Brien Estate,* DC Tex. 5/14/57.

State judgment on what constitutes a charitable bequest is binding. Decedent's will left her estate to her niece "to carry out [decedent's] wishes as best she can as expressed in previous wills." The niece presented a prior will to the Pennsylvania Orphans' Court and indicated her readiness to carry out its provisions. Under the doctrine of incorporation by reference, the Orphans' Court determined that the provisions of the former will were binding and decreed distribution according to its terms. Among these distributees was Yale University. The Commissioner now attempts to disallow a charitable deduction on the ground that the niece, as beneficiary and executrix, was not obligated to make the gift. The Court holds that the determination of the state court as to what is or what is not a charitable bequest is, under the factual situation presented here, conclusive for Federal tax purposes. Consequently, the payment to Yale was deductible as a charitable bequest. *Veech Estate (Howell, Ex'r),* DC Penna., 5/20/57.

Transfer was to save income tax; not in contemplation of death. Less than two years prior to his death, decedent set up a trust for the benefit of various members of his family. The trust would be distributed to the beneficiaries at a time when the decedent would be 60 years old and retired on a substantial retirement fund. The court holds that the transfer was not made in contemplation of death. The purpose of the transfer was to effect a reduction in decedent's income taxes. The grantor was not concerned about his health when the transfer was made and expected to live to retirement age. *Goyette Estate,* DC Calif. 7/12/57.

Failure to prove consideration for transfer results in full inclusion. Decedent, aged 81, transferred securities having a value of $100,000 in exchange for the transferees' promises to pay the income therefrom to the decedent for life and, should such income ever fall below $3,000 a year, to make up the difference. The sole question before the Court is the value, if any, of the transferees' promises to make such contingent annuity payments. To the extent of such value, the transfer was made for a consideration and was consequently not includible in the decedent's gross estate. The Court holds that the executrix failed to furnish any basis for determining whether the promises had any value, or if they did, what the value was. Consequently, the value of the transferred property was included in the gross estate without reduction. *Smith Estate (Greene, Ex'r)* DC Ill. 6/28/57.

Estate's expenses in sale are deductible. The Commissioner disallowed a deduction for expenses in the sale of decedent's real estate by his executor under a general power of sale on the ground that it had not been shown that the sale was necessary to pay decedent's debts. Under the law of Pennsylvania, however, there is a conclusive presumption that a general power of sale in a will is for the payment of decedent's debts. The Court holds that, in the absence of evidence to overcome the statutory presumption, the sale must be considered as having been made for the purpose presumed by law and allows the deduction. *Bartlett Estate* DC Pa. 7/30/57.

Wife may permit husband to manage her property, but it remains hers. Decedent had for a long time prior to his death been in poor health, while his wife had been extremely active in a number of business ventures. In 1936, his wife purchased a liquor store with her own funds. Decedent's feelings of inadequacy and insecurity prompted his wife to permit him to manage the store finances. The decedent utilized some of the proceeds of the business to set up bank accounts in his own or assumed names. He also maintained safe deposit boxes and had an account with stockbrokers. Title to two parcels of real estate was recorded in the decedent's name. The Tax Court rules that the assets found in the possession of the decedent at the time of his death, being the proceeds of the business owned solely by his wife, were her property and not includible in his gross estate. *Rand Estate,* 28 TC No. 115, 8/21/57.

Estate can deduct debt though disallowed by probate court for failure to file claim. The executrix of the estate was also its creditor, the decedent having borrowed a sum of money from her prior to her death. Through inadvertence, the executrix failed to file her claim with the Florida Probate Court within the eight-month period provided by Florida law and as a result the claim became void. Nonetheless, the court holds that the claim is deductible in determining the net taxable estate for estate tax purposes. Deductibility of a claim depends upon its enforceability under local law at the time of decedent's death, not upon its subsequent allowance by a local court. Here the claim was admittedly valid and enforceable, and would have been allowed had the proper steps been taken. *Winer* DC N. Y., 7/11/57.

Life insurance trusts held reciprocal. Decedent had transferred a paid-up life insurance policy on her own life to a trust, the beneficiaries of which were her husband and their children. There was also provision made for the discretionary invasion of corpus on behalf of the husband. On the same day, the husband amended an existing trust, the corpus of which was composed of a paid-up life insurance policy on his life identical in amount with that upon the life of his wife. The amended trust contained provisions substantially the same as those found in the decedent's. The court holds that the value of the husband's trust is to be included in the decedent's gross estate because the trusts were reciprocal. Each created his or her trust in consideration of the other. *Moreno Estate,* 28 TC No. 98.

Best evidence of real estate value is recent sales of comparable property. A husband and wife made a gift of undeveloped real property. The taxpayers had the land appraised and paid gift taxes based on that valuation ($60,000). The Commissioner increased the valuation twice, the first time to $75,000, and the second to $120,000. The court holds that the correct valuation is $75,000, the valuation fixed by one of taxpayer's expert witnesses. The valuation placed upon the property by the Government's witnesses, since, unlike that of the taxpayer's experts, it was not based upon the sales prices of comparable property, was dismissed by the court as too speculative. *Buck,* DC Del., 7/18/57.

Trustee couldn't withhold income; annual exclusion allowed. A wife conveyed real property to her husband as trustee for the benefit of their three minor children. The trustee was directed

"at least annually, [to] use, expend or apply for [the beneficiaries'] benefit and comfort, the net income from the trust-estate as the trustee deems necessary or desirable for said purposes." The Commissioner contends that the gifts were of future interests on the ground that the trustee possessed the discretionary power to currently withhold an unascertained portion of income from the beneficiaries, and consequently denied the annual exclusion. The court holds that the income rights were present interests and qualified for the annual exclusion. The discretion vested in the trustee extended only to the manner and means of expending the income, all of which had to be paid to or applied to the use of the beneficiaries at least annually. *Munger,* DC Ala., 8/13/57.

Premium payments on life insurance trusts are present interests, but marital deduction is denied. A husband set up partially funded life insurance trusts of which his wife was beneficiary. The trust agreements were construed as permitting the wife to call for all of the corpora at any time. The court holds that payments made by the husband to the trustees to be applied against the premiums due on the policies were not gifts of future interests and that consequently the annual exclusion was available. On the other hand, since the wife was not entitled to all of the income of the trusts under the terms of the trust agreements, the husband was not entitled to the marital deduction in computing the gift tax. *Halsted,* 28 TC No. 122, 8/28/57.

New trusts & estates decisions

Short-term trust taxable to grantor; income could come to him. The trust taxpayer created gave the trustee (a non-adverse party) power to accumulate income and to distribute it at the end of the trust (12 years) to the taxpayer or the beneficiary. Ordinarily such a power would make the income taxable to the taxpayer-grantor. He argued that such power in a short-term trust was specifically exempt as it applied to enjoyment of income after the short term. The IRS rules that this power affects income during the period of ten years or more. It is not exempted and the grantor is taxable. *Rev. Rul.* 57-363.

Transfer of interest in common trust fund by participant may be taxable sale. Section 584 provides for the exemption from taxation of a common trust fund maintained by a bank for the collective investment of funds it holds as trustee. The participant trusts are taxed on their share of the income and capital gain and Section (e) also provides for the taxation of a participant upon its withdrawal from the fund. The IRS considers the treatment of a transfer of an interest on the books of the fund at the direction of a beneficiary, as for example, the revocation of a trust, formerly a participant, and the direction by the grantor that the interest be transferred to a newly created trust, or the termination of a participant trust and the direction of the distributee that the interest be transferred to another participant trust. The IRS concludes that where the transfer is equivalent to a withdrawal and reinvestment it must be taxed as a withdrawal, i.e. a sale or exchange of the interest. *Rev. Rul.* 57-335.

Local court decree creating separate trusts effective for Federal income taxes. A decedent's will established a residuary trust for his three children and directed the accumulation of income during the minority of any beneficiary. There were no minor beneficiaries until one of the children died survived by two minor children. The trustees were concerned as to how to segregate income earned on the accumulations for the minors. In an uncontested proceeding, they asked the appropriate local court to declare that separate trusts be established for the minors and that the principal trust pay the proper share of its income into these accumulation trusts. The Commissioner refused to recognize the state court decision, allowed only one trust exemption and taxed all the income at the graduated rates applicable to one trust. The court gives effect to this decree, although it was uncontested, as defining the property rights of the beneficiaries. It allows the principal trust to deduct payments to these trusts for the minors as income required to be distributed currently. *Lindley Estate,* DC Minn., 8/2/57.

Family trusts disregarded; beneficiaries had control over accumulated income. A family corporation's stock was owned, in 1944, 66% by the mother, 13% by the father, and 7% by each of three adult children. The mother made a gift of an additional 7% to each of three trusts, one for the benefit of each child. Each trust had two trustees; various combinations of the children and the husband of the daughter were used so that in no case did a beneficiary serve as trustee of his own trust. The trustees had discretion to distribute or accumulate income. Shortly after the creation of the trusts, the corporation was liquidated and the business operated as a limited partnership. The trusts made no distributions to beneficiaries. All the distributable shares of income were accumulated and reported by the trusts on fiduciary income tax returns. Citing the lack of business purpose for the creation of the trusts [The court is probably on weak ground here, for business purpose has never been required in this setting.—*Ed.*], the common investment policy of the trustees, and the reciprocal nature of the trusts, the court disregards the trusts as lacking substance and taxes the partnership shares for 1945-1947 directly to the beneficiaries. *Kanter,* DC Calif., 7/26/57.

Income from family trust taxed to grantor under Clifford rule. Taxpayer and his wife each owned 50% of the stock of a furniture corporation. They created a trust for the benefit of their three minor children by transferring 60% and 34% of their stock respectively to the trust which then held 47% of the total shares. The trust was irrevocable and was to continue until taxpayer's death, or until the youngest child, then seven years of age, reached 25, whichever event occurred later. Taxpayer made himself sole trustee with broad powers to use the principal and income "as he may see fit." The court finds because of the reservation of broad powers in the grantor, taxpayer continued to be the owner for income tax purposes of the property conveyed to the trust. Accordingly taxpayer and his wife were taxable on long-term capital gain realized when the trust in 1943 liquidated the furniture corporation. *Apicella,* 28 TC No. 110.

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

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Wrong basis taxpayers still have no clear route to proper accounting

by **GEORGE F. SHANNON**

Some taxpayers improperly on the cash method of accounting switched to accrual, without permission, for their first 1954-Code year. Others made no change. The tax treatment for those who did switch is obscured by the possibility of further legislation (the Technical Amendments Bill of 1957 proposed taxing their "saving"). The net effect seems to be that Section 481 will be of no help to the taxpayer caught in this squeeze. Mr. Shannon, who has been deeply involved with these questions, reports the varying positions taken by the Commissioner before and after the 1954 Code, the attitude of the courts, and the effect of proposed legislation. He also brings us up-to-date on his "Bee Company," a particular wrong basis taxpayer whose troubles he has so engagingly described in these columns (4 JTAX 84).

PROBABLY every tax man knows at least one wrong basis taxpayer. Typically, it is a commercial or industrial concern which has grown rapidly, largely by reinvesting untaxed profits. Its returns invariably were filed on the cash basis, although its books may have been converted to accrual. The common denominator among such taxpayers is a large and growing accumulation of untaxed profits invested in accounts receivable, inventories, and prepaid expenses, partially offset by accounts payable and accrued expenses. These taxpayers have something else in common: if they sought permission to change to the accrual basis, the Commissioner's price would be inclusion in the year-of-change income of the total untaxed profits at the beginning of that year. Furthermore, if a taxpayer made the change voluntarily and without obtaining the Commissioner's prior consent, he would risk sustaining the same tax consequences. It cannot be said with assurance that he would have incurred them, but the court decisions inclined enough in that direction to make taxpayers wary of voluntary changes. Consequently, since the Commissioner's price was too high and voluntary change too risky, taxpayers were frozen on the cash basis, even though they knew they were on the wrong basis and that the Regulations under the 1939 Code stated that only the accrual basis would correctly reflect their income.

Meanwhile, revenue agents were regularly examining and accepting these wrong basis returns without questioning the accounting basis. This disregard of the Regulations and economic fact was attributable mainly to a long line of court decisions which were unfavorable to the Commissioner where the change in accounting basis was involuntary, that is, forced upon taxpayers by revenue agents. For example, the courts said accounts receivable on the books at the beginning of the year-of-change couldn't be taxed as part of that year's income (they were income of a previous year) and that inventories on hand as of the same date could be deducted in the year sold, even those claimed as deductions in previous years when suppliers' invoices were paid.

The Commissioner litigated these issues in many courts and with great persistence, but finally bowed to the virtual unanimity of the decisions, even acquiescing in two of them. His principal argument was, of course, that pyramiding income into the year-of-change was necessary to prevent prior years' income from escaping taxation through operation of the statute of limitations. But the courts said the statute was not a one-way street: it operated against the Commissioner, as well as against taxpayers.

An odd and uneasy impasse developed: wrong basis taxpayers were unwilling to change because of the tax hazard, while revenue agents wouldn't force the change because of the almost certain loss of tax revenue. But this impasse was not as total as it might have appeared. There were tax practitioners, revenue agents, and men in higher echelons of the Service who recognized the bad and worsening situation of these wrong basis taxpayers.

There was general agreement in one large area, namely, that the revenue agent was within his rights in requiring taxpayers to compute the net income of all open years on the accrual basis. Disagreement was confined to a single point: the disposition to be made of untaxed income at the beginning of the year-of-change. There was much hard bargaining on this point. At first, revenue agents merely conceded—and very grudgingly—that accounts receivable would not be included in the year-of-change income. Later, when it became apparent that the great preponderance of court decisions were against the Commissioner, revenue agents were somewhat less firm in their insistence that opening inventories must be included in the year-of-change income. Finally, neither opening accounts receivable nor opening inventories were included in this income.

This, then, was the status of cash to accrual transitions when the new Code was enacted July 1954. Section 481 of the 1954 Code, which was applicable to taxable years beginning on and after January 1, 1954, prescribed entirely new rules for adjustments required by changes in methods of accounting. In general, they provide that where taxable income is computed under a method of accounting different from the taxpayer's method for the preceding year—as from cash to accrual—"there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change." Observe the use of "shall"; its effect is to make these

adjustments mandatory, whether the change is voluntary or otherwise.

Fortunately, or, perhaps, unfortunately, the statute also included an important exception to this general rule, namely, a provision that "there shall not be taken into account any adjustment in respect to any taxable year to which this Section does not apply," that is, to pre-1954-Code years. At the time Section 481 was enacted, and at present, the best available interpretation of it was, and is, in the Senate Finance Committee Report on the new Code. Two brief excerpts from it follow:

"If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deductions is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doublings up which are due to the change in method which must be adjusted."

"Your committee's bill provides that the portion of the net transitional adjustment which corrects errors made prior to 1954 will not be made. The transitional adjustments in all future changes under your committee's bill will be those resulting from a change in accounting method determined (under the facts) to be necessary to adjust for erroneous treatment of items subsequent to 1953."

Two relief provisions, called "limitations of tax where adjustments are substantial," appear in subsection (b) of Section 481. Both are applicable to 1954-Code years only, and provide tax relief by spreading back adjustments. One is a simple three-year spreadback. It is available where the net adjustment exceeds $3,000, and its effect is to limit the additional tax resulting from the change to the increase in tax obtained by spreading the net transitional adjustment evenly over the year-of-change and two preceding years. The other is more complex, and is available only to taxpayers whose records support an allocation of the net transitional adjustment to years prior to the year-of-change. In those cases, the additional tax resulting from the change cannot be more than the increase resulting from spreading back the net transitional adjustment to consecutive years preceding the year-of-change.

Example. Assume the only adjustment in the year-of-change is adding $3,300 opening inventory to income. Assume further that the year-of-change is 1960, and that the records will support spreading the $3,300 over 1957, 1958, and 1959. Then, the tax on the $3,300 in 1960 (that is, the year-of-change) is limited to the increase in tax resulting from spreading back the $3,300 over 1957, 1958, and 1959.

There are conditions qualifying the right to these limitations and special rules regarding their computation, all of which appear in Section 481(b). In addition to these relief provisions, the Section states, in subsection (c), that the transitional adjustments may be taken into account in any manner or in any years, before or after the year-of-change, as the Commissioner's Regulations may prescribe. This provision is without effect, however, since no Regulations have been proposed or adopted under Section 481.

The taxpayer's quandary

From the taxpayer's viewpoint, the great question raised by Section 481 was whether the exception from it of pre-1954-Code-year adjustments would have the tax effect promised in the Senate Finance Committee's report. One group of tax accountants maintained that it

THE EFFECT OF CASH TO ACCRUAL TRANSITIONS

IT SEEMS CERTAIN that taxpayers still erroneously filing cash basis returns can now obtain no tax benefit from Section 481 of the 1954 Code, even if proposed Section 24 of the 1957 bill is not enacted. Assume, for example, a calendar-year taxpayer whose net transitional adjustment was $100,000 as of December 31, 1953 and $150,000 as of December 31, 1956. Obviously, the $100,000 would have been collected in the 1954-56 period, and would have entered into the computation of the cash basis taxable income for those years. In other words, the taxpayer has paid the tax on this $100,000. It is true that as of December 31, 1956 there would be more than an equivalent amount in untaxed income, but this $150,000 is not within the Section 481 exception since earned in years to which the 1954 Code applies. Consequently, if the taxpayer's 1956 return is examined and the revenue agent compels conversion to the accrual basis, the entire $150,000 will enter into the additional tax computation.

Under the present Code, such taxpayers are entitled only to the limited relief provided by Section 481(b). Theoretically, they could file amended accrual basis returns for 1954-56 and credit to earned surplus the net transitional adjustment as of December 31, 1953. However, it is reasonable to believe, in view of the Commissioner's uncooperative attitude and proposed legislation, that these amended returns would not receive favorable consideration. Probably, these wrong basis taxpayers have no alternative other than to concede that the entire net transitional adjustment will be taken into account and to concentrate on spreading its tax effect over as lengthy a period as possible.

Taxpayers who, without permission, changed from cash to accrual in their first 1954-Code year are in a somewhat better position, even though Section 24 of the 1957 bill is aimed squarely at them. Some will be benefitted by operation of the statute of limitations on March 15, 1958, although probably not many whose net transitional adjustment is large. In these cases, the statutory bar will be forestalled either by automatic application of Section 6501(e), which extends the assessment period to six years where 25% or more of gross income is omitted from the return, or by waivers of the statute, obtained under threat of jeopardy assessment. The tax saving prospects of all changed basis taxpayers would, of course, be adversely affected by enactment of Section 24 as proposed, because of its retroactive effect. Fortunately, the Technical Amendments Bill, which includes Section 24, did not become law this year, and there is reason to believe that the Senate Finance Committee will not in 1958 accept Section 24 in its present form. If the Senate Committee were to do so, it would, in effect, reverse the position it took when the 1954 Code was enacted and violate the confidence of taxpayers who acted in reliance on Section 481 and the committee's explanation of it.

would, and supported its position with the claim that the intent of Congress was to grant wrong basis taxpayers at least as much tax relief as the courts had allowed in involuntary conversion cases. Some zealous practitioners claimed that under the exception the entire amount of untaxed income at the beginning of the year-of-change could be taken into earned surplus tax-free. It soon became apparent, however, that this view was extreme, and the claim was modified to the more reasonable position that untaxed income at the beginning of the first open year was tax-free.

There was another and opposing group which believed that these tax-free income claims were unjustifiably optimistic. Some of these practitioners believed that if the first 1954-Code-year return was filed on the accrual basis (and the untaxed income at the beginning credited to earned surplus), the taxpayer would have made a voluntary change, and, therefore, would be subject to tax on the entire untaxed income in the year-of-change. Others held that in filing on the accrual basis, taxpayers placed themselves in an inconsistent position, thereby entitling the Commissioner to reopen closed years and to assess additional taxes for them. All those in this opposing group appeared to share one conviction: that even if the Section 481 exception did mean what it said and even if Congress had intended to legislate a tax benefit for these wrong basis taxpayers, the Commissioner, by administrative action and inaction, would deny it to them.

The Commissioner's "iron curtain"

As was natural under the circumstances, taxpayers attempted, in various ways, to obtain from the Commissioner's office an official explanation of Section 481 and a statement of his intentions regarding the transitional adjustments. Many taxpayers filed formal requests for permission to change their method of accounting from cash to accrual. According to Research Institute of America, this permission was granted in cases where taxpayers agreed to take all the transitional adjustments into the year-of-change income. However, where the request was conditioned on the use of Section 481 to create tax-free income, it was ignored by the Commissioner's office. Requests for Rulings on the application of Section 481 to specific-fact situations were similarly ignored, and informal requests addressed to revenue agents and others in the Service were equally nonproductive.

Meanwhile, Regulations under the 1954 Code began to appear, including some on intricate tax matters. Regulations on corporate liquidations, for example, were first proposed on December 11, 1954, and those on consolidated returns, July 2, 1955. Since Section 481 is brief and is concerned with simple subject matter, the Commissioner's silence began to be regarded by tax practitioners with foreboding which gained in intensity as the months passed. The first official announcement from the Commissioner's office regarding Section 481 was published January 3, 1956, and was very little better than the silence which had preceded it. The announcement (Treasury Release IR-139) is as follows:

"Applications to change methods of accounting: A number of taxpayers have made inquiries relating to applications for permission to change their methods of accounting under the provisions of Section 446 of the Internal Revenue Code of 1954 which involve adjustments under Section 481 of the Code. Pending issuance of the Regulations under those Sections, the Internal Revenue Service will not act on applications for permission to change methods of accounting which involve adjustments under Section 481 of the Code. Taxpayers who have filed timely applications at the time their income tax returns are due should prepare their returns in accordance with their existing methods of accounting. When final Regulations under Sections 446 and 481 have been issued, the Service will consider each such pending application on its merits for the taxable year for which permission to change the method of accounting was properly requested."

The announcement said nothing whatever regarding the status of tax returns which, without the Commissioner's consent, had been converted to and filed on the accrual basis for the first 1954-Code year. Neither did it explain how a timely application to change could have been filed for 1954 by a calendar-year taxpayer, since the final date for its filing was four months before enactment of the 1954 Code. However, the announcement did promise Regulations under Section 481 and consideration of timely applications at that time. But these promises weren't kept. Instead, there was complete silence on the issue for more than another year until, on February 15, 1957, TIR No. 41 was issued. It read in part, as follows:

"In view of the announced consideration of technical problems in connection with Section 481 by the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means and the consequent possibility of legislation which would amend this Section, proposed Regulations interpreting the Section will not be issued at this time. . . ."

This Release confirmed the fears of those who had said the Commissioner would not permit taxpayers to obtain the tax savings to which they appeared entitled under Section 481. His method of denying the savings, it now became apparent, was, first, refuse to advise taxpayers, and then to eliminate all possibility of benefit by retroactive legislation.

Decisions on changes in methods

During the 30-month period from July 1954, when the 1954 Code was enacted, to February 1957, when TIR No. 41 was published, tax practitioners read with particular interest court decisions in changes-in-accounting-method cases. These decisions, it was thought, might furnish some indication or information of assistance to tax practitioners struggling with Section 481 problems. Unfortunately, all such cases were concerned with pre-1954-Code years. Furthermore, in my opinion, each of these cases turned on its own particular facts, and no portent of decisions under the 1954 Code can be deduced from them. There are, however, at least three cases docketed with the Tax Court in which changes in accounting methods in 1954-Code years are at issue. It is quite possible that no authoritative interpretation of Section 481 will be available until one or more of these cases is tried and the decision rendered.

Bee Company and Section 481

The Commissioner's silence and practitioners' controversies on the interpretation of Section 481 did not in any respect modify wrong basis taxpayers' obligation to file returns under the 1954 Code. The experience of one such taxpayer may be of interest. Bee Company, a calendar-year corporation, is engaged in the retail sale of furniture for cash and on installments. [For earlier reports on the Bee Company's troubles see 4 JTAX 84.—*Ed.*] Its tax returns for all pre-1954-Code years were filed on the cash basis, although the books had been

on the accrual basis for many years. As of January 1, 1954, beginning of its first 1954-Code year, its net transitional adjustment (that is, accounts receivable plus inventories and prepaid expenses and minus accounts payable and accrued expenses) was $916,000. Its tax returns to and including the calendar year 1951 had been examined and cleared by revenue agents, none of whom had proposed conversion to the accrual basis.

Bee's calendar-year 1954 return was filed late in 1955 at the expiration of the period covered by the second extension in its filing date. During the 15 months following enactment of the 1954 Code, Bee had attempted to obtain some authoritative expression of opinion on the tax status of its net adjustment, but without success. Bee Company, therefore, acting with the courage of its convictions, filed the 1954 return on the accrual basis, without obtaining the Commissioner's prior consent to the change, and on the return credited the entire $916,000 to earned surplus as of January 1, 1954. A schedule showing its computation accompanied the return, as did a statement that the credit was made to earned surplus in accordance with the taxpayer's understanding of Section 481 of the Code.

Revenue agents' examination of the 1954 return commenced in February, 1956, and continued for several months. Initially, the agents maintained that Bee had voluntarily changed its accounting basis, and was subject to tax on the entire net transitional adjustment in 1954, the year of change. Bee Company's representatives met this claim by saying that the change was involuntary, rather than voluntary, since it was forced upon the company by the 1954 Code. Furthermore, they said, the company had not and did not propose to change the basis on which the open years' (1952 and 1953) returns had been filed, since they were governed by the 1939 Code, as amended, and the taxpayer relied on the case line unfavorable to the Commissioner. The inconsistent-position question was not raised by the revenue agents.

The Bee Company settlement

Eventually, after much hard bargaining, a compromise settlement was reached under which the net transitional adjustment of $720,000 as of January 1, 1952 (first day of the most remote open year) was credited to earned surplus and returns for the calendar years 1952 and 1953 were converted to the accrual basis. In other words, $720,000 of the $916,000 was taken into earned surplus tax-free, but the balance was added to 1952 and 1953 income, resulting in a total additional assessment of $104,000. The agents' waiver of restrictions on assessment was prepared in accordance with this settlement and in December 1956 the $104,000 additional tax, plus interest, was paid.

It does not appear that this settlement reflects present Service policy. More probably, it is merely an application of the policy which had led to satisfactory compromise settlements in the year or two preceding enactment of the 1954 Code. This policy recognized the court's rejection of the Commissioner's contention that transitional adjustments accumulated in closed years should be included in the year-of-change income. It, therefore, permitted the income represented by the net adjustment to escape taxation, provided that all open years were converted to the accrual basis. Otherwise stated, while the Commissioner collected only half a loaf, he also corrected a bad situation which reflected unfavorably on his administration.

Technical Amendments Bill of 1957

In June of this year, the Committee on Ways and Means reported to the House of Representatives its "Technical Amendments Bill of 1957," which it described as a "major step in the elimination of . . . unintended benefits and hardships in . . . existing income, estate, and gift tax provisions. . . ." Section 24 of the bill is entitled "Adjustments Required by Changes in Method of Accounting," and its effect is well described in the following quotations from the report:

"Section 481 of the 1954 Code for the first time provided statutory rules with respect to these adjustments" (that is, those required by changes in method of accounting). "This Section requires these adjustments to be made in full to the extent that they are attributable to 1954 or a subsequent year. However, no adjustments are required which are attributable to years before the application of the 1954 Code. . . .

"Your Committee sees no reason why the pre-1954-Code-year adjustments should not be made, when taxpayers, of their own volition, have changed their method of accounting. . . . Your Committee recognizes, however, the need to prevent the 'bunching' of taxable income in these cases. . . .

"This bill does not affect present law with respect to pre-1954 adjustments where the change in method of accounting is not initiated by the taxpayer. When the change is initiated by the taxpayer, the adjustments, to the extent attributable to years before 1954, must be made in computing taxable income, but they may spread over a period of as much as ten years."

The report also states that the proposed Section would apply to all changes in methods of accounting originated by taxpayers, that is, both those where the Commissioner's permission to change had been requested, and those where it had not. Since changes made with the Commissioner's consent obviously would be on his terms, the provision appears to be aimed exclusively at taxpayers who changed accounting methods without requesting or obtaining this consent.

Proposed "spreadforward" provision

One of the most unusual features of the proposed Section is its "spreadforward" provision. The amount which may be spread forward is the net adjustment which would have been required had taxpayer changed his method of accounting in his first 1954-Code year; $916,000, in Bee Company's case. This net adjustment must, however, increase taxable income by more than $3,000, and is defined as a consolidation of adjustments, both plus and minus, as accounts receivable, inventories, and accounts payable.

The spreadforward period, generally, is the year-of-change and nine immediately succeeding years, subject to some limitations. For instance, if a taxpayer has not been engaged in the same trade or business for nine years prior to 1954, the spread is limited to the year-of-change and the same number of succeeding years as taxpayer was in the same trade or business prior to 1954. Then, too, any portion of the spreadforward adjustment not previously taken into account must be taken into account where a taxpayer's status changes. Status changes include the death of an individual or cessation of his trade or business, termination of a partnership, and cessation of a corporate business

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(unless acquired by another corporation under Section 381 of the 1954 Code).

The effect of Section 24, if enacted as proposed, on settled cases such as Bee Company's, is uncertain. The committee report includes some comment which indicates that it would have no effect, particularly a statement that "if there are any changes in methods of accounting which have already been specifically allowed these should not be upset by this provision."

Other interpretations of the Bill

Section 24(d) of the bill, which states its effective date, is capable of other interpretation, however. Its general rule is that the amendments made by the provision shall apply to any change in method of accounting where the year-of-change is a taxable year beginning after December 31, 1953 and ending after August 16, 1954. The only exceptions to this rule are cases where both the following conditions exist: (a) The taxpayer has applied for a change in the manner provided by the Regulations; and (b) The taxpayer and the Commissioner have agreed to the terms and conditions for making the change.

While these terms and conditions have been agreed upon, Bee Company did not apply for a change in the manner provided by the Regulations, and, therefore, its settlement is not excluded from Section 24, if technically construed. ☆

New accounting decisions this month

Useful life and salvage value of leased automobiles determined. Taxpayer was engaged in the business of leasing automobiles as a sole proprietor. He entered into an agreement with a family corporation, U-Drive, to lease to the latter all of the automobiles. U-Drive in turn leased about 40% of the automobiles to customers for extended periods of time and rented the remainder to the general public on a short-term basis. In determining useful life and salvage value for depreciation purposes the court finds that the automobiles which taxpayer leased to U-Drive for use under extended-term leases had a useful life of three years and a salvage value of $600, while those leased to U-Drive for short-term rental had a useful life of 15 months and a salvage value of $1,375. *Evans,* TCM 1957-156.

TV station can't depreciate intangible contract rights. Upon purchase of an operating television broadcasting station taxpayer acquired a network affiliation contract with a principal network, together with customer contracts for spot time on local and national station broadcasts. The cost of the network affiliation contract (restricted by FCC rules to a two-year period) is held not to qualify for depreciation since the value of the contract tends to increase with the passage of time and network affiliations in general remain fixed for very long periods. The cost of the local and national spot contracts is also not subject to depreciation. These contracts are ordinarily renewed and the payment for them was in effect for goodwill. *Rev. Rul.* 57-377.

Finders fee paid by banks amortizable over life of mortgage. A finders fee or buying commission paid by any type of bank to a third party for introducing a prospective mortgagor is to be capitalized over the life of the mortgage. However, where a bank has already deducted the full commission in a year barred by the statute of limitations, it may not again deduct a pro rata part of the same commission in a subsequent year. *Rev. Rul.* 57-400.

Construction cost of mausoleum recoverable through crypt sales. A commercial cemetery corporation constructed a mausoleum with available space for several hundred crypts. Since the corporation intends to sell the crypts in the ordinary course of business, the IRS rules that the mausoleum is not properly depreciable. The taxpayer should treat the construction cost of the mausoleum as a cost of crypt sales by a ratable allocation to each crypt. *Rev. Rul.* 57-376.

Auto dealer's income is full car price despite withholding by finance company. The Tax Court adheres to its position that an auto dealer must include in his income the full sales price of cars sold with loan company financing even though a reserve was withheld by the finance company equal to at least 5% of the total outstanding on the dealer's contracts. The Tax Court noted that it had been reversed on this issue by the Fourth Circuit (*Johnson,* 233 F.2d 952), but declined to follow that court. *Hansen,* TCM 1957-113.

Vacation pay ruling extended again; to be applied after January 1, 1959. Rev. Rul. 54-608 permits the accrual of vacation pay only if liability to a specified employee is clearly established and the amount can be computed with reasonable accuracy. Application of the ruling had previously been deferred to July 1, 1957. The Service now announces that enforcement is again deferred; it will not be applied to tax years ending prior to January 1, 1959. There will be no further extensions. *Rev. Rul.* 57-325, TIR 57-55.

Taxpayer's inventory accepted. The Commissioner increased taxpayer's inventory, multiplying the reported figure by 25. Taxpayer was a ship chandler and the inventory in question had been surplus World War I goods. The court finds there is nothing to substantiate the arbitrary write-up. The Commissioner was also in error in disallowing $1,000 of purchases as personal items withdrawn from the business. The court finds that very few items bought were of a personal nature and such purchases were on specific order by ships officers and were properly accounted for. *Richardson,* TCM 1957-122.

Cash basis taxpayer must deduct loss when it occurs. The court interprets decedent's 1931 brokerage transactions as amounting to a large loss sustained in that year after he had borrowed money, turned over to the broker in a vain attempt to reduce that debt to an amount covered by his collateral and thus prevent a forced sale. The broker did sell him out however. This loss was deductible in 1931 not in subsequent years as decedent repaid the money he had borrowed from others. *Bramer Estate (Kaplan, Ex'r),* DC Pa., 7/30/57.

Property taxes accruable not in year levied but in year they became a lien. Allegany County property taxes on taxpayer's property for the year 1951 were levied in December, 1950. In prior years the tax became a lien in the year of levy. Due to a change in New York state law the lien for 1951 tax did not attach, and taxpayer did not become personally liable for the levy until the year after the levy, i.e., 1951. The court holds the taxes could not be accrued

during the year of levy but were properly deductible only in 1951. As a result, no real estate tax is deductible for the 1950 return. *Messer Oil Corp.*, 28 TC No. 124.

Sole proprietor can't use different accounting period for business. An individual reporting on a calendar year was an employee for part of the year and then operated as a business proprietor for the balance of the year. The IRS rules he must include in his income not only his earnings as employee, but the business operations to December 31. If he desires to change his accounting period, he must first obtain the prior approval of the Commissioner. *Rev. Rul.* 57-389.

CAPITAL GAINS

"Lease" of sprinkler system ruled a conditional sale. A five-year lease providing for the installation of an automatic fire protection sprinkler system in a warehouse and office building called for "rental" payments over the five-year period aggregating the cost of the system and its installation. The lessee was given the privilege of renewing the lease for an additional five-year period at a nominal rental. The IRS holds the lease is a conditional sale. Accordingly the rental payments are capital expenditures, recoverable through annual depreciation over the life of the system. *Rev. Rul.* 57-371.

"Lease-option agreement" was a sale. Taxpayer rented farm property having a fair market value of $46,500 under a lease-option agreement which provided that he would pay two years rental at $15,000 and would have an option to purchase at $31,500. The court notes that the "rentals" and "option price" amounted to $46,500, and finds that the parties intended a sale of the property at the time of the agreement. Payments thereunder are held to be installments on the purchase price, not deductible rent. *Beus*, 28 TC No. 132.

Commissioner not bound by agreement allocating damages for loss of goodwill. Taxpayer, a movie theatre operator, had claimed antitrust damages against certain film companies on the ground that they deprived him of first run movies to benefit their own theatres. Settlement was made out of court by an agreement which specifically allocated three-fourths of the amount to the loss of goodwill, and the other one-fourth to the loss of profits. Taxpayer accordingly reported three-fourths of the net proceeds as long-term capital gain. The Commissioner claimed that the entire amount represented recovery of lost profits and was taxable as ordinary income because there was no proof in the negotiations leading to the settlement as to any damages for loss of goodwill. The court agrees, holding that the Commissioner is not bound by the terms of the settlement agreement. Since there was no proof of actual loss of goodwill, the entire amount is held taxable as ordinary income. *Basle*, TCM 1957-169.

Capital gain on sale of subdivided inherited real estate. Taxpayer engaged a broker who subdivided and sold one half of certain property she had inherited After a few isolated sales by the taxpayer eight years later, she sold the remaining land in one tract. It is not clear which sales are in issue here; however the court holds that the actions of taxpayer did not constitute a trade or business and the profits on the sale were capital gains. *Potter*, DC Ga., 7/26/57.

Capital gain on sale of inherited tract despite subdivision and improvement. Taxpayers, a lawyer and his sister-in-law, were joint owners of land which had been held by their family for several generations. They tried, without success, to sell it as a unit and then authorized a real estate firm to subdivide it, put in streets and sell lots. All of the actual planning and negotiation was done by the real estate agents. The sales continued over five years; two are in issue here. The court holds the land never lost its character as a capital asset; taxpayers did not go into the real estate business, they merely chose the best way to dispose of an inherited asset. *Mackall*, DC Va., 8/5/57.

Indian pays no tax on gain from sale of allotted land. Income derived by an Indian from the sale of alloted land held in trust for him by the U. S. under the General Allotment Act of 1887 is exempt from tax. *Rev. Rul.* 57-407.

DEDUCTIBILITY

Payments to settle trust litigation not deductible by corporation. Taxpayer's sole stockholder left his shares in trust for his four children. The children sued the trustees, who were also a majority of the directors of taxpayer, to require the payment of substantially all of taxpayer's income to them, not merely the amounts declared as dividends. They also questioned the application by the trustees of certain other trust income. The decision of the lower court was against the beneficiaries, and they appealed. To settle the litigation, taxpayer paid $100,000, to be distributed $25,000 to each beneficiary. Taxpayer contended there was a corporate purpose in the settlement payment, since a reversal might require payment of the entire surplus, leaving inadequate reserves and working capital. But the court finds the corporation's interest was too remote and disallows the deduction as an ordinary and necessary business expense. *E. W. Edwards & Sons*, DC N. Y., 8/9/57.

Window and wall replacements capital expenditures. Taxpayer operated a drug store on the ground floor of his apartment building. He also occupied one apartment and rented the others. During 1952 he spent over $500 replacing the apartment windows and over $1700 replacing a wall in the cellar. The court holds the expenditures are in the nature of capital outlays and hence non-deductible in full. Small repairs, and the cost of a refrigeration unit to keep ice cream machinery operating are allowed as business expenses. The court also sustains the Commissioner's reduction of the expenses by $180 which he attributed to taxpayer's personal use of room and utilities. *Croff*, TCM 1957-163.

Lawsuit expenses in trademark action not deductible. Taxpayer owned the trademark "Sanymetal" and sued another company to enjoin its use of "Sanimetal." To avoid heavy litigation expenses, taxpayer paid the other company $15,000 to cancel its mark. Recognizing that the $15,000 payment should be treated as a substitute for legal fees rather than purchase price for the trademark, the court nevertheless disallows the deduction. The expenditure was incurred to earn income in the indefinite future, and thus should be capitalized. *Sanymetal Products Co.*, DC Ohio, 7/9/57.

Dutch elm disease no casualty. The IRS points out that a national magazine was in error in referring to an allowable casualty loss for an ornamental tree lost by Dutch elm disease. Since there

is no sudden action, this loss would not qualify as a casualty loss under the Code. *Field Release* 56.

WHAT IS INCOME

Bank deposits were loan repayments, not income. The Commissioner determined deficiencies against taxpayer based on inclusion of certain unexplained deposits in taxpayer's income. The court concludes from the evidence that the deposits were the property of taxpayer's son who was serving in the armed forces, and largely represented repayments of advances which taxpayer made to him. The deposits were therefore not income to taxpayer. *Lilianski,* TCM 1957-135.

Pay, forfeited by court martial, not income. The IRS distinguishes between a forfeiture of pay and a fine and holds that forfeited pay never was income; consequently withholding of income tax is made only on the reduced pay actually disbursed. *Spec. Rul.* 3/18/57.

Share of profits received by widow was income in respect of a decedent. Taxpayer's husband had been a member of an insurance brokerage partnership. The partnership agreement provided for payment of a share of the profits for a ten-year period to the representative of a deceased partner. The value of this right to profits for ten years had been included in the husband's estate. She included each year's profit in income and later claimed a refund on the theory that one-tenth of the estate tax valuation of the right should be deducted in each year. The refund was allowed but now the Commissioner claims it was erroneously paid and sues to recover it. The court holds she must repay it. The payments received were income in respect of a decedent under Section 691 and were fully taxable to her. She could not recover tax-free the estate tax value of the income right; that was in no sense a cost or basis to her. It would defeat the purpose of Section 691 to allow any offset against this income. *Ellis,* DC N. Y., 8/13/57.

Specific bequest which includes compensation as executor excludable from income. An employee received a specific bequest which the will specifically stated was to include all compensation for her services as executrix. Since the right to the sum was not contingent upon her performing the duties of executrix, the Service holds it is not to be treated as taxable compensation but constitutes a nontaxable gift or bequest. *Rev. Rul.* 57-398.

Membership dues taxable income even though allocated to pay off fixed debt. Voluntary pro-rata payments by shareholders to the corporation may represent contributions to capital. However the IRS rules that portion of annual membership dues received by a taxable organization which is allocated to a special reserve fund to pay interest and principal on a mortgage cannot be excluded from the corporate gross income since the payment of dues is not a voluntary contribution. *Rev. Rul.* 57-375.

Advance designation of rental allowance for parsonage required. The IRS points out that the final Regulations on rental allowances to ministers for a parsonage differ from the proposed Regulations. The proposed Regulations had required that prior to payment the allowance be designated as in lieu of a parsonage in minutes, employment contract or other appropriate instrument. The final Regulations require such advance designation only for payment made after December 31, 1957. For payments prior thereto, designation prior to December 31, 1957, is sufficient. *Notice* 334.

Can avoid tax by rejecting contest prize. An individual refused to accept an all-expense-paid vacation trip he won as a prize in a contest. The IRS rules that the fair market value of the trip is not taxable to him. *Rev. Rul.* 57-374.

Payments into union-established unemployment fund nondeductible; benefits taxable. A union established a voluntary fund for the purpose of providing its members with unemployment benefits. Participants paid certain amounts into the fund, depending upon the type of membership desired, and received corresponding benefits under specified conditions. Amounts paid into the fund are held to be nondeductible while the benefits received constitute income to the recipient to the extent they exceed the payments made by him. *Rev. Rul.* 57-383.

Nurses under Public Health Service program have tax exempt scholarships. Awards received by degree students and others taking advanced courses of training for professional nurses at certain universities under the Public Health Service program are considered scholarship or fellowship grants. Degree students may exclude the entire amount subject to the limitations (teaching or other services rendered) of Code Section 117(b)(1), while non-degree students may exclude up to an amount equal to $300 times the number of months received during the taxable year, for not more than 36 months. *Rev. Rul.* 57-370.

Payments to interns, resident doctors and administrative hospital residents fully taxable. Stipends received by interns and resident doctors performing services at a medical training hospital to which they are appointed periodically are compensation for services and not scholarship or fellowship grants under Code Section 117. *Rev. Rul.* 57-386. Similarly, amounts received from a hospital by a student enrolled as a candidate for a master's degree in hospital administration who is required to serve as an

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Journal of Taxation, Inc.
William S. Papworth, *Business Manager*

Sworn to and subscribed before me this 14th day of October, 1957.

Irving Lent, *Notary Public*
(My commission expires March 30, 1958)

"administrative resident" are also taxable as compensation and do not qualify as excludable scholarship or fellowship grants. *Rev. Rul.* 57-385.

Wife's travel expenses are income to husband when paid for by his employer. His family-owned corporation sent taxpayer, an officer and minority stockholder who had just been married, on a business trip to Europe, and as an inducement to have him go, paid the expenses for his wife who accompanied him. Her presence during the business trip had no business purpose. The court holds the corporate payment of the wife's expenses was not excludable from income as a wedding gift, but represented either additional compensation to taxpayer for his services in going on the trip at the particular time or was a distribution of earnings. The findings of fact state that the Commissioner allowed only half the expense as a deduction to the corporation. *Silverman,* 28 TC No. 121.

Contingent expense allowance is income. A state court judge with a fixed salary received an additional $200 per month as "contingent expense allowance." No accounting was required for such sums. They are held to be compensation for services rendered and therefore includible in gross income. *Geer,* 28 TC No. 112.

OTHER DECISIONS

For bad debt deduction, must prove loans did not become worthless in prior year. Taxpayer, a subsidiary, advanced funds to another subsidiary of the same parent. The parent transferred the stock of the debtor corporation to taxpayer which thereupon merged the debtor's assets and liabilities. Taxpayer claimed the advances became worthless in the year of merger but the court denies the deduction because taxpayer failed to prove that the obligations had not become wholly worthless in a prior year. *Seaboard Commercial Corp.,* 28 TC No. 119.

Advances to daughter's publishing company not a bona fide debt. Taxpayer's daughter, a full-time student, has at all times been claimed by taxpayer as a dependent. The daughter and a college friend organized a corporation for the purpose of publishing a monthly magazine devoted to literature, fine arts, and music. Taxpayer furnished the corporate capital on behalf of his daughter and made advances from time to time for the use of the corporation. After two issues the magazine folded up. The court denies taxpayer a bad debt deduction for the monies advanced on the ground that no bona fide debtor-creditor relationship ever existed. Taxpayer is held to have simply made advances to his daughter's magazine project out of a commendable paternal interest in furthering her literary pursuits. *Rothbard,* TCM 1957-155.

Court agrees taxpayer's accountant erred in reporting sale. Taxpayer testified that he protested when his accountant prepared his return showing that he had purchased stock and resold it. The accountant died before the trial, but from the documents and oral testimony the court concludes that taxpayer was right and the tax return in error. The stock was sold directly by the other stockholder to the third party, and taxpayer had made no purchase and sale. *Perkins,* TCM 1957-128.

Landlord taxable on rents despite assignment of lease to wife. Taxpayer, the owner of a commercial building, formally assigned certain leases with tenants to his wife. She reported the income, though he claimed depreciation and other deductions. The district court held that she was the possessor of an interest in the property and taxable on the rents. This court reverses. Under state property law she had nothing but the right to the rents; the transaction was a mere assignment of income and incapable of diverting the tax. However, even if she should have other rights, the transfer of income will not be recognized for tax purposes. Under the *Horst* line of cases it is clear that the donor in this intra-family gift retained sufficient control over the property which gave rise to the income to be taxable on it. *Shafto,* CA-4, 7/15/57.

Wages and rentals are "business income" for computing net operating loss carryback. In 1947 taxpayer sustained a net operating loss from the operation of a hotel, a farm, and a seafood business, and a nonbusiness loss from the sale of the hotel assets. [Under the 1954 Code loss on disposition of business assets is an operating loss.—*Ed.*] In determining the available net operating loss carryback under the 1939 Code, taxpayer treated the entire income earned by himself and his wife from salaries, bonuses, directors' fees and rentals as "nonbusiness" income (which does not under the Code reduce the net operating loss available as a carryback). The Commissioner determined that the income was "business income" and must be offset against the net operating loss rather than the nonbusiness loss. The Tax Court says merely that the question was decided against the taxpayer in *Lagreide,* 23 TC 508, and upholds the Commissioner's determination. *Roberts,* TCM 1957-145.

Property condemned as unsafe not involuntarily converted. Taxpayer owned rental property which under local housing laws was declared unfit for habitation unless extensive repairs were made. Rather than do this, taxpayer is selling the property. The Service rules that the housing department action is not a condemnation, or threat of condemnation, permitting non-recognition of gain on conversion. Condemnation under Section 1033 means taking of private property for public use upon payment. *Rev. Rul.* 57-314.

Basis of patents in tax-free exchange reconstructed. Taxpayer, a corporation engaged in the manufacture of precision instruments, obtained six patents from the inventor under a tax free exchange of stock for the patents. The basis of the patents to the transferor (which basis remains the same for the corporate transferee) could not be substantiated as the inventor lost all of his records pertaining to the expenses and costs of developing, engineering, constructing, making, and testing the items covered by the six patents. Using estimates and other evidence, the court reconstructs the cost basis for each patent to be used in computing depreciation. *Brunson Instrument Company,* TCM 1957-154.

Promissory note had no value. For services rendered, a cash basis taxpayer received in 1951 a $7,000 unsecured non interest bearing promissory note payable "240 days thereafter." At time of issuance, the maker of the note was without funds. Taxpayer was in need of immediate cash during the year of receipt and on 10 or 15 occasions attempted to sell the note but without success. The court concludes the note had no fair market value in 1951. *Williams,* 28 TC No. 114.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

How to control tax and accounting aspects of retirement from a partnership

WE MIGHT AS WELL face the lugubrious fact that every person who is a member of a partnership will sooner or later cease to be one. And in spite of our brightest hopes, every existing partnership will sooner or later cease to exist. This is the prime reason why every partnership should have a partnership agreement.

Probably 75% of the partnerships in this country have no written agreement. In many cases they are proud of the fact that they have been able to operate as long as they have without reducing to writing the terms of their operation. In most situations there is no need for an agreement prior to the time that one of the partners dies or retires. It is then that they wish that they had set forth clearly the terms under which a particular partner could leave the partnership. There are few partnerships in existence which can summarily make a cut-off of their operations and forthwith pay out in cash to a retiring partner or the estate of a deceased partner the exact amount to which he is entitled. In most cases there is work in process which is difficult to value and a full payment in cash would place a great burden on the remaining partners.

The retirement of a partner creates legal, accounting and tax problems which are closely interrelated. Under the Uniform Partnership Law, when a partner dies or retires, he is entitled to receive his interest in the property and profits of the partnership. From an accounting standpoint, this means that he should receive his capital account and his undistributed profits of both prior years and the current year up to the date of his retirement. In many partnerships, of course, provision is made to give the retiring partner more than his legal minimum. However, even in such partnerships, it is common to provide that if a partner is expelled from a partnership, or leaves because of bankruptcy, he will receive no more than must be paid to him under the law. We will discuss later in this article payments which go beyond the legal requirements. But, since, in almost every partnership, there will be instances where the retiring partner will receive no more than he is legally entitled to, we will discuss that first.

Dividing partners' capital account

On the books of many partnerships, we find that the initial capital and the undrawn earnings of prior years have been combined in one capital account. The earnings of the current year are seldom credited to the partners until the close of the year. The tax treatment of the payment to the retiring partner of his capital account and undistributed profits of prior years is identical; they are both considered tax-free in his hands. The remaining partners will receive no deduction from income for making this payment. The retiring partner's share of the current year's profit is, however, taxable as ordinary income to him, and deductible from the distributable income of the other partners.

There is no real harm in combining the undistributed profits of prior years with the initial capital into one capital account. From a practical standpoint, however, the two should be kept separate. On the retirement of a partner he will not report as income the amount of his capital and undistributed profits of prior years. A revenue agent, however, may well inquire as to whether the capital account should be accepted at face value for tax purposes. Many accounts include a goodwill factor for property contributed by the partners. Under the Internal Revenue Code of 1954 the basis of partnership property contributed by partners is the same in the hands of the partnership as it was in the hands of the contributing partner. If the capital account is a hodge-podge of the original contribution plus undistributed earnings of prior years, it will be very difficult to establish that the entire amount represents a tax-free item.

If, on the other hand, there is one separate capital account for the original contributions and the undistributed profits account can be tied in with the tax returns as of the end of each year, a great deal of trouble may be saved. If the original capital contribution consisted of cash, a notation on the books of account in the capital account showing that to be the fact, will probably satisfy a revenue agent. If, as is more likely to be the fact, the partnership is a continuation either of a prior partnership or of an individual proprietorship, copies of the last return of the previous partnership or proprietorship and of the first return of the new partnership should establish that the basis in the hands of the partnership is the same as that of the predecessor. Remember that the Service has the habit of destroying both individual and partnership returns after they have reached a certain age, and unless the partnership preserves these returns in its own files, they may be unavailable when needed.

It is exceedingly important that the capital account and undistributed profits account be maintained for each individual partner and not lumped into one net worth account which includes the initial capital and undistributed earnings of prior years. It is a terrific accounting job to go through the records of a partnership to determine for any particular partner his exact share in the undistributed earnings when the balance each year is lumped in one account and not shown separately for each partner.

Earnings for year of retirement

Assuming that the partnership recordkeeping is adequate so that you can determine and establish the amount of the capital contribution and the undistributed earnings of prior years, the next problem is the determination of the retired partner's share of the earnings of the current year. Assuming that he dies or retires in the middle of a year, you have the practical problem as to whether you must make a complete cutoff of the books or whether you can use some approximation. Although this may seem a minor problem, in many partnerships it

has caused the expenditure of a great deal of time in discussions between the bookkeeper and the remaining partners. A cutoff of the books of a cash basis partnership in the middle of a month can present a very distorted picture. Similarly, a cutoff in the middle of a year of a partnership which is engaged in a seasonable business can cause a substantial amount of injustice either to the retired partner or to the remaining partners. In some businesses the beginning part of the year is the most prosperous and the end of the year is one in which the major portion of the expenses are incurred and special bonuses and other items paid. If a partner dies in the middle of a prosperous season, his share will be much greater than it actually should be.

To eliminate trouble for the bookkeeper and prevent injustices of this type, it is suggested that the clause fixing the amount to be received by a partner who dies or retires provide for a reduction in his partnership interest rather than a cutoff as of the date of death. Under such a provision he would remain a partner until the end of the fiscal year of the partnership but at a reduced percentage. Thus a partner who had been receiving 10% retires in the middle of the year. Under a properly worded partnership agreement his percentage would be reduced to 5% and he would receive that much of the entire year's profits. This eliminates a difficult accounting problem and acts to insure a fair treatment for both the retiring partner and the remaining partners.

Termination of accounting year

Such a provision in the partnership agreement relates simply to the determination of the income to be paid to the retiring or deceased partner. It would not affect the taxable year of the partner or partnership involved. Under Section 706 of the Code, if a partner dies, the taxable year of the partnership is not automatically terminated but continues until the end of its normal year. If, however, a taxpayer sells or exchanges his entire interest in the partnership or if his interest is completely liquidated. the partnership year closes as to him at that point. These provisions can have varying tax effects and should be taken into account.

A partner who contemplates retirement from a partnership should give careful consideration to the tax effects of this Section. If the partnership is on a calendar year it will make little difference. If, however, the partnership is on a fiscal year, it may make a great deal of difference as to what date he picks to retire. Thus, in the case of a partnership on a June 30 fiscal year, if a partner decides to retire as of December 31 it will result in the inclusion in his calendar year for individual tax purposes of 18 months of partnership income. If he should decide to retire as of January 31, he will not suffer from doubling up of income.

In the case of the death of a partner, the partnership year does not terminate as to him but continues as usual. This was inserted in the law for the benefit of partnerships on a fiscal year. Thus, in the case of our partnership on a June 30 fiscal year, when a partner dies on December 31, a bunching of income in the year of death is prevented. Instead of having 18 months of income in the year of death, he has only 12 months in the year of death, the other six falling in the year following, when the return will be made by the executor.

In the case of partnerships on fiscal years, this statutory provision will in most cases result in a tax savings for the deceased partner. However, if the partnership is on a calendar year, the exact opposite may result. Let us assume a calendar-year partnership and the death of a partner on November 30. His executor will file a return for the decedent for the period from the beginning of the year through November 30 and will report practically no income, with the result that the exemptions and deductions will, to a large extent, go to waste. The first year of the estate will include 11 months of partnership income and practically no deductions. As a result of this inequity, there is a movement on foot to amend this Section and give taxpayers the option to decide whether the partnership year should end at death or continue. In the case of two-man partnerships, the present Regulations provide for the continuance of the partnership in spite of the fact that after the death of one partner it will be in effect a sole proprietorship.

Book value v. real value

The amount of the capital and undistributed profits will normally be determined with reference to the books of the partnership. In many cases, the amount so arrived at will be satisfactory to all involved. In some instances, however, it will not. Often the death of one partner will require the complete dissolution and liquidation of the partnership. The amount realized on such liquidation will often not equal the book value. For that reason, the remaining partners should be given the option either to pay book value to the retiring or deceased partner or to liquidate the partnership and divide its assets among the parties involved.

In some partnerships the true value of the partnership assets will be considerably in excess of the book values. For example, an apartment building constructed in the thirties or forties will have a book value of far less than its present market value. Under such circumstances, the partnership agreement should provide for an appraisal by a group of disinterested real estate experts. The remaining partners should then have the option to buy the deceased or retiring partner's interest at the appraised value or to sell the property and divide the proceeds among the partners in accordance with the agreement.

The appraisal is a satisfactory manner of handling this problem when the property involved is one piece of real estate. Where, however, the partnership has a factory, machinery and inventory on the books at less than their true value and there is valuable goodwill, an appraisal clause in a partnership agreement will generally not solve the problem. If the partnership agreement calls for the payment of book value to a deceased or retiring partner, the problem can be solved by periodically revising the books to show the true value of the assets. Such revision, of course, must be agreed to by all of the partners. The agreement itself can provide for an annual reappraisal of the value of the partnership property, which appraisal can either be placed on the books or kept as a separate document. Or certain assets can be specifically revalued in the agreement.

At the end of this article are suggested paragraphs for the retirement provisions discussed herein. Paragraphs 1, 2 and 3 should be present in every agreement because they provide the bare legal minimum. Paragraph 4 is an optional clause to be used where a greater sum is payable and of course, the amount and length of payment are not inflexible.

Personal service partnerships

The most difficult problems involving the retirement provisions of a partnership agreement arise in the case of per-

SUGGESTED AGREEMENT COVERING WITHDRAWAL OF PARTNERS

1. (a) If any partner shall, in the opinion of a majority in interest of the partners, be guilty of misconduct of such character as to render it impracticable for the then partners to carry on the partnership business together, the offending partner may be expelled from the partnership.

(b) There shall thereupon be paid to the expelled partner, or his nominee or representative, the balance in his capital and undistributed profits accounts, as of the beginning of the fiscal year in which such expulsion shall occur, less any withdrawals therefrom, or charges or losses therein, to the date of expulsion.

(c) As of the close of the fiscal year in which such expulsion occurs, there shall be paid to the expelled partner, or his nominee or representative, his pro rata share of the income of that fiscal year, based on the ratio of number of days prior to expulsion to the number of the days in the fiscal year.

(d) The interest of the expelled partner to the partnership property and earnings shall cease as of the date of expulsion. He shall thereafter have no rights against the partnership of the remaining partners as to the property or earnings except as to payments set forth above.

2. Any partner may retire from the partnership as of the end of any calendar month, after giving the other partners at least 60 days' notice in writing of his intention so to do. Any partner who shall be disabled so that he cannot perform his duties as a partner for a continuous period of six months may be retired from the partnership by a vote of a majority in interest of all other partners, as of the close of the month in which such six-month period ends. Any partner who shall be adjudicated a bankrupt, or who shall make an assignment for the benefit of creditors, may be retired from the partnership, by a vote of a majority in interest of all other partners. In the event of the retirement or death of a partner, neither the partnership nor its fiscal year shall be terminated and the remaining partners shall continue the business, and shall succeed to the interest of the retired or deceased partner by paying to him or his representative the then balance in his capital and undistributed profits account, and his pro rata share of the income of that fiscal year based on the ratio of the number of days prior to death or retirement to the number of days in the fiscal year.

3. Payments of capital and undistributed profits account balances, and of the share of the current year's income, shall be made ..... percent (....%) within ..... days after the end of the fiscal year in which retirement, expulsion or death occurs, and the balance in ..... equal monthly installments until paid in full.

4. Each retired partner, or his estate in the event of death after retirement, and the estate of each deceased partner, shall, in consideration of past services, receive a share of the earnings of the partnership for that year and subsequent years, determined as follows:

(a) Each such retired partner or deceased partner's estate shall receive, as of the close of the fiscal year in which death or retirement occurs, a percentage of the earnings, which percentage is the sum of the following:

(I) One-twelfth of his last profit-sharing percentage, multiplied by the number of months from the beginning of the fiscal year to the end of the month in which death or retirement occurs; plus

(II) One-forty-eighth of his highest profit-sharing percentage, during the previous five years, multiplied by the number of months from the end of the month in which death or retirement occurs, to the end of the then fiscal year.

(b) Each retired partner or deceased partner's estate shall receive, as of the close of each fiscal year succeeding that in which his death or retirement occurs for ten years, a percentage of the partnership earnings equal to one-fourth of his highest profit-sharing percentage during the previous five years. Said ten-year period shall be reduced by one for each year he lacks of age 65 on retirement, and further reduced by one month for each full month during the previous five years during which he was absent for disability.

(c) If a partner shall retire at any time other than as of the close of a fiscal year, the number of years during which he may participate in the earnings, as set forth above, shall be nine. If a retired partner competes with this partnership in any way after the close of the fiscal year in which he retires, but prior to the end of the fiscal year in which the last payment to him under paragraph (b) above, is due him, he shall forfeit all payments for the fiscal year in which such act occurs, and all subsequent years, but shall not be required to return any advances made to him against earnings of such year.

5. Payments of shares of the earnings for years subsequent to death or retirement shall be made within 60 days after the close of each such year, except that there may be loaned to a retired partner or the estate of a deceased partner, on June 1, September 1 and December 1 of the years following the first full year after retirement or death, amounts equivalent to 20% of the total amount received during the previous year, adjusted to conform to the percentage interest for the current year.

6. A retired partner, so long as he is receiving payments hereunder, shall not at any time perform work for any client or clients of the partnership, and shall not at any time disclose to any person, firm or corporation the name or names of any client or clients of the partnership, or of any of its transactions, nor at any time use the firm name by itself nor in conjunction with his own name or otherwise, nor use the words "formerly of ....." nor any other combination of words containing the firm name.

sonal service partnerships such as lawyers, accountants, engineers, and architects. In this type of partnership, on the death or retirement of a partner there is almost always present a number of uncompleted matters which are difficult to value. A lawsuit may be pending which the firm has taken on a contingent fee basis. Engineering contracts and

architectural contracts may be in the process of completion which could result in substantial profits or losses, depending on work to be done.

The deceased or retiring partner of such a partnership may have been responsible to a large extent for the prosperity of the partnership. He may have been quite a business-getter and have brought in numerous clients. If the partnership as a whole is now serving these clients, they will not leave when he leaves, and the remaining partners will benefit accordingly.

There is another element which is often taken into consideration in drafting the retirement provision for such a partnership. Many of these partnerships are large and can continue with practically no loss of income on the death or retirement of a partner. If the partnership agreement provides for payments for a number of years after death or retirement, it will add to the stability of the partnership and will operate as a form of mutual insurance. The benefits of such a provision are similar to those inherent in the profit-sharing and pension plans of corporations. They increase the stability of the organization since a partner who has been with a firm for twenty years and has built up a large retirement credit will be loathe to leave simply for the purpose of receiving an increase in his current income.

Retirement benefits

In this type of partnership, it is customary to provide retirement benefits over and above the amount to which the partner is legally entitled. The provisions determining the amount to be paid are probably as many as there are partnership agreements in the country. In some agreements it is provided that the remaining partners shall value all of the work in process and pay to the retiring or deceased partner his share thereof. The agreement usually provides that this valuation shall be final and non-contestible. This form of clause is probably productive of more illwill and acrimony than any other. It lets the buyer set his own price and usually results in dissatisfaction on the part of the retiring partner or, in the case of death, on the part of his family. It takes a great deal of time out of partnership operations to sit down and attempt to place a value on every pending matter.

As an alternative, we may provide for the continuation of the income of the deceased or retiring partner for a period of time or we may provide for a continuing percentage interest in the partnership operations for a period of time. Generally speaking, the amount of payments to be made after retirement will be less than those received prior to retirement and will be spread out over a period of time. Thus the agreement might provide that the amount the retiring partner had received during the preceeding two years of his membership should be paid out to him over a five-year period. It might provide that if he had been receiving 10% of the profits prior to retirement he would receive 5% of the profits for a three-year period. In the form at the end of this article, payment for ten years of one-fourth of his highest profit-sharing percentage during the five years prior to retirement is provided for. The length of time during which he would continue to receive payments might be based upon the length of time he had been a member of the partnership. These provisions avoid difficult valuation problems, prevent unnecessary bookkeeping and accounting work and are simple in application.

Unrealized receivables and goodwill

Under Section 731 of the Code, upon a distribution by a partnership to a partner, no gain is recognized except to the extent that the money distributed exceeds the adjusted basis of the interest in the partnership. In other words, a cash payment which does not exceed the partner's original capital, plus his undistributed earnings of prior years, is nontaxable.

Section 731 is not applicable where it conflicts with Section 736, which relates to payments to a retiring partner or a deceased partner's successor in interest. Section 736 provides that amounts distributed in exchange for the interest in partnership property shall not be considered as a distributive share of income. It provides for capital gains treatment of such distributions under certain circumstances. Thus, in the case of a real estate partnership where the property is appraised and the retiring partner received his share thereof, any gain realized would be a capital gain. However, in the case of a personal service partnership where the amounts paid are for uncompleted or past services, the amounts received would be taxable as ordinary income. Section 736 specifically states that payments for unrealized receivables of the partnership cannot be treated on the capital gains basis, nor can payments for goodwill unless the amount thereof is set forth in the partnership agreement.

The partner who is retiring would like to have the entire amount he receives treated as payment for goodwill or for specific partnership property so that he can report any gain as a capital gain. The remaining partners, however, would like to treat all amounts payable to the retiring partner as a distributive share of the income so that they can reduce their distributive shares accordingly. The problem is primarily one of arithmetic.

Normally, a retiring partner is at a lower tax rate than are the remaining partners. The benefits of capital gains rates mean less to him than the right to deduct these amounts by the remaining partners. In many cases the amount paid to the retiring partner will not be for an interest in any property and cannot be properly ascribable to property so as to give him capital gains treatment. There are some instances, however, where it is possible to characterize a large amount of the payments for goodwill, which will reduce the income taxes of the retired partner.

The partners, at the time of drafting the partnership agreement, should give careful consideration to the net effect of characterizing any amounts as goodwill on the aggregate tax liability of all of the partners, including that of the retiring partner. Under ordinary circumstances, they will find that the higher the goodwill factor, the higher the income taxes of the entire group. As a means of compromising the conflicting interests, an excellent solution is to increase the amount payable to the retiring partner to make up for the additional tax he will have to pay as ordinary income. It will normally be found that the additional amount payable to him to compensate for the tax difference between ordinary income and capital gains will be less than the taxes saved by the remaining partners.

Normally a law partnership will not have a goodwill factor that can be bought by the remaining partners. The Commissioner will probably contest vigorously any attempt to put goodwill into the partnership agreement of a purely personal service professional partnership. This should not cause any dismay to the members of such a partnership because they will find that a careful drafting of the partnership agreement, making all payments to a retiring part-

ner ordinary income, will result in a much lower tax to the group as a whole than any attempt to save one partner taxes at the expense of the others.

In conclusion, the agreement should provide specifically for the payment of the capital account and of all undistributed earnings of prior years. For the year of death or retirement, and for such subsequent years during which payments are to be made, the partner's percentage should be reduced. Such a form will simplify the accounting and tax problems, and should result in fair treatment to all involved. It complies with all legal requirements. ☆

New partnership decisions this month

Partnership income taxed to children in family partnership where capital was purchased with children's funds. Taxpayer had manufactured veneer for many years, leasing a warehouse owned by his wife. In 1941 they formed a partnership, he contributing the business, she the warehouse. In 1942, each transferred a portion of his capital to each of their three children, 20, 18 and 15. The transfer was in form a gift, but the court holds it was in reality in satisfaction for debts to the children arising out of old gifts plus interest. But whether the interest arose by gift or not, the court holds the partnership valid for tax purposes. There was a real intent to join together in business. *Williamson,* Ct. Cls., 7/21/57.

Unfinished contracts purchased by surviving partner entitled to an allocated-cost basis [*Acquiescence*]. One of two partners of an architectural firm purchased his retiring partner's interest and thereafter continued the operation of the business as a sole proprietorship. They had fixed the purchase price by estimating the profits to be derived from certain contracts transferred. The court holds that the surviving partner is entitled to a basis equal to an allocated part of the purchase price in computing the gain realized upon their completion by him as a sole proprietor. He purchased contracts, not a partnership interest, and unlike goodwill or customers lists, the contracts would have no value after completion. *Silling, Sr.,* 27 TC 701, *acq.* IRB 1957-32.

Election to adjust partnership basis must be filed for first effective year. Code Section 754 permits an optional adjustment of the basis of partnership property after a transfer of partnership interests if an election is made. When the cause of the transfer is an unforeseen event such as the death of a partner there is no difficulty in making the election. The general rule is that the election is made by a written statement filed with the partnership return for the first taxable year in which the election is to become effective. Consequently the election is filed with the return for the year of death. *Rev. Rul.* 57-347.

Partnership with trusts for children upheld; it made $130,000 on $6,000 capital. Taxpayer was, with his wife, sole stockholder in a woolen converting firm which he and about six employees had operated for many years. In 1945, when materials for his regular business were scarce, he saw the opportunity to go into the ribbon business. He made cash gifts of $2,000 each in trust for his two children, and with $2,000 of his own went into partnership with the trusts. The three shared equally in profits after a $75 a week salary for him. The partnership was dissolved in 1946 after it had earned some $130,000. The Commissioner taxed all the income to the father, relying largely, the court says, on the argument that this was a personal service business. The court holds however, that capital was needed, and was small because of the rapid turnover. It concludes that the parties did intend to join together in the present conduct of a business and that the partnership must be recognized. *Peisner,* TCM 1957-115.

"Rental" payments to partner's widow really purchase of interest. Under decedent's will his executrix was authorized to continue as partner in an automobile agency which held a Buick franchise. Because Buick refused to issue a franchise to a partnership of which an estate is a member, the executrix entered into an agreement with the remaining partners (taxpayers here) to (1) sell the estate's interest in the partnership for $50,000; (2) receive title to the agency premises which she would lease back to a new partnership of the remaining partners for a percentage of the profits, and (3) convey title to these premises to the new partnership at the end of the year. The parties agreed the "lease" was merely a security for the promise to pay a portion of the profits. The Tax Court held that the entire payment (both the $50,000 and the rent of some $28,000) was for purchase of the decedent's interest and not a division of partnership profit. The remaining partners are taxable on the entire income, without deduction of the "rent" as expense or allocation of it as a share of profit. This court finds substantial justification for this finding of fact and affirms. *McKelvey,* CA-3, 8/1/57.

Family partnership in doll manufacturing business upheld. Taxpayer and his wife had been engaged in the doll manufacturing business for many years as chief executives of a corporation taxpayer and the estate of a brother owned. A partnership was formed in 1945 to take over the corporate business, with taxpayer, his wife, a son, the estate and two daughters of the deceased brother as partners. This was replaced by a partnership of taxpayer, his wife and their four sons. Distribution of income of both partnerships is here in issue. Part of the income allocated by the first partnership is taxed by the court to the father. However, the second partnership is sustained. In those years the mother and all the sons were genuine partners joined together to carry on the business. Part of the time some of the sons were in the army but they kept in touch with the business. *Slarsky,* Ct. Cls., 7/17/57.

Post-1951 partnership upheld under Culbertson test. Taxpayer, an established construction man of advanced age, orally formed a partnership with his unmarried daughter who did the paper work, and his son-in-law, who actually ran the business. At issue here was the partnership's validity in 1952. The court held that the 1951 Code provisions on family partnerships were inapplicable because the son-in-law was not a member of the family as defined in Section 191 of the 1939 Code as amended (Section 704(e) of the 1954 Code). Nor was there any evidence that the interests of the parties were acquired by gift. The court then turns to the test laid down by the Supreme Court in *Culbertson* (337 U. S. 733) and concludes that the parties really intended to join in business as partners and their partnership must be recognized as valid. *Paul,* TCM 1957-170.

TAX STRATEGY, NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Practitioners find many faults with IRS personnel management, pay, morale

FIVE YEARS AGO when the IRS was shaken by revelations of corruption, extensive revision of the organization was undertaken. The reorganization was followed by recurrent complaints that the measures taken at that time had had disastrous effects on the morale of IRS employees, had led to "buck passing" and that inability to get decisions except at the highest level had created a top-heavy supervisory structure. The Advisory Group of Practitioners (see box) appointed to assist the Mills Subcommittee on Internal Revenue Taxation gave considerable attention to these matters, but their recent report frankly admitted that more study was necessary before they could offer solutions.

As suggested by the Advisory Group and the subcommittee itself, the IRS is also working on the problem. In a recent issue of "The Commissioner's Letter" addressed to fellow employees of the IRS, Commissioner Harrington said that the IRS is now in the process of studying each of the recommendations. "Even in cases in which we believe that the questioned policies are completely sound, we intend to give them thorough and impartial reconsideration. These studies will take a good deal of time." Tax men hope that the work will proceed with dispatch; even necessary and desirable reforms cause confusion and delay and will be an obstacle to prompt closing of cases until the new procedures are firmly established.

Getting and keeping personnel

The practitioners opened their report with the fundamental problem—getting and keeping high-quality employees. "It is the opinion of your Advisory Group," the report stated, "that the Internal Revenue Service is faced with a serious personnel problem as follows: (1) Shortage of personnel, clerical and technical, particularly of top-quality, competent career personnel at all working levels, plus (2) a personnel recruiting and attrition problem stemming largely from inadequacy of compensation, some statutory deterrents to advancement and some factors related to morale, such as certain functions of the Inspection Service, and treatment of employees in the audit of their own tax returns.

"In considering personnel problems of the Internal Revenue Service the magnitude of the Federal operation and its importance in the Federal administrative structure must be constantly borne in mind.

"Today the Internal Revenue Service has a force of over 50,000 employees operating out of 928 offices spread throughout the country. The most recently announced 12-months internal revenue collections amount to $77,652 million. Each year the Service receives for handling, audit, and check more than 90 million tax returns. The number of separate payments of tax it has to process, post and run through its accounts must exceed each year a billion transactions. A fair estimate of the number of taxpayers it has to do business with is 60 to 65 million.

"The task of the Service is without a doubt the most sensitive of any task in the Federal administrative structure. Operating under a huge body of technical, complex tax laws, it has to do business directly with an enormous number of taxpayers and in a manner which will encourage their cooperation with a system geared largely to full reporting and self-assessment. The single most important factor of successful Federal tax enforcement in this country is taxpayer attitude.

"Absolutely essential to collecting this huge annual tax sum and to ascertaining and enforcing the collection of deficiencies is a well trained, well paid, competent body of employees with high morale and integrity, skilled in conciliation, and largely dedicated to making a career of employment in the Service. Any major weakness in the personnel structure stemming from difficulties of recruitment, low quality of recruitable people, personnel attrition through early separations of top-quality personnel, an inordinately large percentage of weak personnel, and poor morale, can be incredibly costly through revenue losses and through lowering of that essential taxpayer confidence and cooperation in the self-assessment system. Executive or legislative unwillingness to face up to this reality would be one of the most expensive mistakes the Federal Government could make.

"This is true even in the classes of nontechnical clerical personnel. The accounts, payments, and records of over 60 million taxpayers simply have to be accurately checked and currently posted, papers must be filed, stenographic requirements must be fully and quickly met.

"The Service today is seriously short of top-quality personnel at many levels in the salary structure. For the future, as veteran qualified personnel die, resign, or retire, the availability of required replacements from lower levels with personnel of similar quality will be a formidable problem. The Service faces a serious difficulty today even in recruiting sufficient clerical personnel in the lower grades, and its inability to secure qualified stenographic help can justifiably be descibed as desperate. For the technical activities such as audit and legal work, not only is there a difficult recruitment problem as to both number and quality, but the separation rate is inordinately high. The pattern, to a degree which causes serious concern, is that promising young people, after a short period of perhaps four or five years during which skill and competence in Federal tax matters have been acquired, leave the Service for much more remunerative employment in private industry and professional firms.

"During the years prior to the 1952 reorganization, the Bureau of Internal Revenue was traditionally well manned with veteran personnel at all levels, a large majority of whom were quite content to make public service a career. Personnel attrition then could probably be described as a percentage which is healthy for any organization to permit

the infusion of new blood and new ideas at all levels. Since the 1952 reorganization, many veteran employees have left the Service. Apparently the reasons included discontent with the new system, the bringing into the Service at high levels of people with no background in the Federal tax structure, changes in the tax law which increased the demand of industry and the professions for trained tax people, and various morale factors. Today the wage scales are inadequate to attract and retain the many top-caliber employees the Service must have.

"As to problems of pay scales and personnel recruitment, this is no doubt common to most Federal agencies today. It is fair to ask, however, whether the function of the Internal Revenue Service in enforcing the tax laws and collecting the national revenue is not of such exceptional importance that the Government cannot risk impairing Internal Revenue Service effectiveness by inadequate pay scales and impediments to advancement. If consideration is to be given to up-grading salaries in the Internal Revenue Service to assist its recruitment and retention of the career personnel it needs, there is a very practical consideration as to how and when it will be done. If left to the present pattern of the Civil Service Commission it is doubtful that anything will ever be done—simply because the Commission will doubtless hold this agency in line with other old-line Federal agencies. Protestations of needs by Service officials will be measured by the same standard.

"We understand also that there is a question as to lack of balance in the number of top grades assigned to the Chief Counsel's staff and also within the Assistant Commissioner breakdowns. We understand that the operation of the Whitten amendment,[1] which has restricted opportunity for advancement, is an important factor in personnel attrition and morale. We also understand that personnel recruitment and attrition are affected by geographical considerations. That is, the salary structure of the Service is on a nationwide basis, regardless of the "labor market" in which employees are working. There are wide variables in the country between "low cost" and "high priced" labor markets, and the effect of these variables should be examined.

"If the necessity for a decision to upgrade Internal Revenue Service classifications is accepted, then it seems very desirable that some form of summary action be devised to reverse promptly the present personnel trend. The Advisory Group recommends prompt review of salary scales, particularly in the upper grades, with a view to increases where necessary, elimination of some of the restrictions on advancement, and the addition of a number of so-called supergrades to the Service."

Probably because jurisdiction of these matters is lodged in other committees of Congress, the subcommittee merely recommended that consideration be given to the Advisory Group's proposals. The subcommittee said: "When consideration is given to the overall problem of salary and job classification, your subcommittee recommends that consideration be given by the appropriate committees of the Congress to the peculiar needs of the Internal Revenue Service, particularly with respect to whether the Commissioner should not have authority to establish training and experience requirements for appointments to such technical and supervisory positions as he may designate and to place such positions in grades of the general schedule of the Classification Act under such standards as he may decide are appropriate to meet the needs of the Service."

Inspection Service

The Advisory Group then turned to two factors "which appear to have needlessly hurt the self-respect of Service personnel and their pride in their work. One is the combination of duties of the Inspection Service in its twofold functions referred to as 'internal security' and 'internal audit.' The other is the treatment which has been accorded for Service employees in the audit of their own income tax returns.

"The two functions of the Inspection Service are described by the Service as follows: (a) Internal security: . . . investigating wrongful conduct of service employees . . . . (b) Internal audit: . . . Internal audit is a fact-finding group. . . . Its function is to carry on a systematic verification of accounts and financial transactions . . . and *a review and evaluation of policies, practices, and procedures at all organizational levels.* Internal audit in connection with its review and *evaluation of policies, practices, and procedures does review case files;* . . . the review of case files is nothing more than a means of determining that policies, practices, and procedures are effective, continue to serve their intended purpose *and are being properly interpreted and consistently applied.* . . . Internal audit is a widely utilized management control device throughout both Government and private industry. In the Revenue Service, with so many of its employees dealing with the public in work that involves large elements of trust and discretion, *the need for an independent review is obvious.* (Italics supplied.)

"The Inspection Service was . . . established during the period of the public revelations of tax scandals which shocked the country. In the feeling of the time, and the importance of restoring public confidence in Federal tax administration, it was perhaps too much to ask deliberate, sober consideration of the long-term effect of this administrative operation on the whole structure of Federal tax administration. It is at least desirable today, from a perspective of five years, in a much different atmosphere, to suggest that there should be reviewed and reconsidered the necessity for and desirability of an internal audit operation by the same organization charged with enforcing internal security.

"We do not disagree at all with the internal security function of the Inspection Service as we understand it. Nor do we disagree with that part of its internal audit function, as we understand it, covering 'systematic verification of accounts and financial transactions.' But the use of the same organization charged with control of internal security, with all the connotation implicit in this term, as a 'management control device' for 'independent review' of the exercise of 'trust and discretion' by employees, including 'review and evaluation of policies, practices, and procedures at all organizational levels,' is bound to have, and we believe it has had, an adverse effect on employee morale and willingness to take responsibility for decision."

The Advisory Group, and the subcommittee, had a lot to say about the necessity and desirability of audit as a management tool, and we will come to that part of the report later. Incidentally, the discussions of auditing in these reports sometimes gets a bit hard to fol-

[1] Section 1310(c) of the Supplemental Appropriation Act of 1952, as amended, provides: ". . . No person in any executive department or agency whose position is subject to the Classification Act of 1949 as amended shall be promoted or transferred to a higher grade subject to such Act without having served at least one year in the next lower grade." However, a 1952 amendment (Public Law 375, 82d Congress) provides: ". . . in order to avoid undue hardship or inequity the Civil Service Commission, when requested by the head of the agency involved, may authorize promotions in individual cases of meritorious nature."

low. After all, the main function of the IRS is to "audit" the taxpayers' returns and the word is constantly used in that sense. Then the IRS has its own internal "audit" staff to scrutinize all the activities of IRS personnel. But, semantic difficulties aside, it is clear that the subcommittee agreed with the Advisory Group that it is poor policy to have the Inspection Service responsible for both internal security and auditing. The subcommittee report said that "the techniques and knowledge required to perform the internal security functions are not complementary to the functions performed by the internal audit, and in our opinion these distinct functions should be placed under separate Assistant Commissioners. Rather than combining security functions with other functions of a nonsecurity nature, it is believed that the Commissioner should study the possibility of combining all security functions under one Assistant Commissioner, reporting directly to him. Thus, he may find it effective to combine the intelligence function with the internal security function. Both of these functions are concerned with security, one from the standpoint of the taxpayer and the other from the standpoint of the employee. This would eliminate various intelligence groups in the field and provide a straight line to the Commissioner on all intelligence and internal security operations."

Employee tax return audit

"Beginning in 1952," the Advisory Group said, "morale of Service employees has been adversely affected by the income tax return audit treatment to which they were subjected. There have been recent minimizing changes in this practice which will be discussed. The treatment accorded Service employees differed greatly from that applied generally to taxpayers, including employees of other Federal agencies, and stemmed back to the 1952 investigation by the Subcommittee on Internal Revenue. As late as January 18, 1955, I. R. Mim. 55-5 (now substantially modified) required that every employee, except minor clerical or housekeeping personnel, be audited regularly. This was described as a measure '. . . to insure the integrity of officials and employees, rather than as a conventional audit program . . .' Auditing agents were directed to obtain a financial statement from the particular employee prior to beginning the audit. In any case resulting in a tax deficiency of $100 or more 'regardless of the basis' a copy of the agent's report was required to be sent to the Inspection Service.

"I. R. Mim. 55-5 was completely revised on August 11, 1955, and the coverage rule was limited to an annual audit of officials and employees occupying positions in grades GS-13 and above. The requirement for securing a financial statement was dropped. The requirement for reporting deficiencies of $100 or more, regardless of the basis, to the Inspection Service was retained and to it was added a rule for reporting 'an aggregate of $150 or more' to the Inspection Service.

"It would seem that the recent modification of the tax return audit treatment of employees (particularly as to the financial statement) should help considerably to mitigate the morale effect of the employee audit program. However, the damage done by the former practice cannot be quickly dissipated. Moreover, there is still a substantial area where there can be a problem of adverse effect on morale. In particular, the requirement of reporting in every case deficiencies in excess of $100 (or over an aggregate of $150) to the Inspection Service, considering that there can be infinite innocent reasons for differences of opinion as to tax liability, and considering also the internal security connotations of the Inspection Service, is a form of treatment not accorded other taxpayers or Federal employees. Such a matter does not seem to be an internal security matter unless there is involved fraud or dealings of an irregular nature.

"The policy of exceptional tax return audit treatment originating in the atmosphere of the 1951-52 situation was evidently considered very important to help restore public confidence in the integrity of the then Bureau of Internal Revenue. The question may be fairly posed today: Is it desirable administrative policy?"

Auditing IRS employee returns today

The subcommittee's report discloses some recent changes in IRS policy in auditing the returns of its employees, but these do not, in its opinion, go far enough.

"The Commissioner, in a letter dated February 14, 1957, advised the subcommittee that there has been a further change in . . . policy in accordance with the following statement: A review of our policy respecting the examination of the income tax returns of Internal Revenue Service employees has been underway for some time. As the result of that study, I am now able to announce to you a major change in the policy. Henceforth, the returns of Service employees will not be subject to mandatory examination merely because they are Service employees, instead those returns will be made available for audit classification at the regional level rather than at the local level and they will be screened in accordance with the same selection standards applicable to other taxpayers.

"The subcommittee understands that in the future, returns of employees in grade 13 and above will be treated just as those below that grade are treated at present. That is, all Service employee returns will still be grouped, screened and examined as a class separate and apart from taxpayers generally, although the procedures employed will be the same as applied to taxpayers generally. It is the understanding of the subcommittee that the screening work will be done by the regional analyst so that the district employees will not screen their own returns. If this is true, then the Commissioner should give consideration to instructing the employees in one district to send their returns to some other district where they would be handled as taxpayers generally. This would relieve the regional analyst for other work. The subcommittee believes the Commissioner

Advisory Group

MEMBERSHIP of the Advisory Group appointed by Mr. Mills consists of the following well known tax practitioners:

Eugene F. Bogan, Chairman
Mark E. Richardson, Vice Chairman
John H. Alexander
Michael D. Bachrach
Bernard H. Barnett
Kenneth W. Bergen
J. P. Goedert
James D. Head
Allan H. W. Higgins
J. Paul Jackson
J. B. Jarratt
Harry K. Mansfield
Robert N. Miller
Leslie Mills
Seymour Mintz
George E. Neal
C. Rudolf Peterson
James K. Polk
H. H. Scaff
Troy G. Thurston
Charles N. Whitehead
Laurens Williams

should give study to further revision of this procedure since the continued grouping of employee returns as a class is bound to affect Service morale.

"While the subcommittee is gratified to learn that the Service has discontinued its former practice of requiring annual 'net worth' statement from existing Service employees, it is understood that such a statement is still required in the case of new employees in enforcement and executive positions.

"It is recommended that the Service give further study to this matter and either discontinue the present requirement or provide uniform and simple standards for establishing net worth, which means a statement of assets and liabilities as of the date of entering the Service. The subcommittee feels that the present practice will have a deterrent effect upon the securing of able and qualified men for the Service."

IRS internal audit

Criticism of the IRS' own internal audit system has centered around two charges in addition to the undesirability of having internal audit part of the Inspection Service (discussed above). The other two charges are that there are two uncoordinated reviews: that of the internal audit division of the Inspection Service and that of the Regional Commissioner's audit division. From the tax practitioner's point of view this means that reaching a decision is made difficult because of the natural tendency of the IRS man to consider the probable reaction not only of his own technical superiors but also of the various auditors who may question his disposition of the case. The other criticism of the internal audit organization is that sometimes cases which the taxpayer had thought were completely settled are reopened.

The Commissioner himself, a CPA and for many years a partner in a national accounting firm, is a firm advocate of internal auditing as a management control. The subcommittee report quoted two March, 1957, memoranda of his to regional commissioners and district directors.

"Having spent the greater part of my life in the auditing profession, I have observed a great many internal audit operations and I have a real appreciation of the value that an effective internal audit function can be to an organization such as the Internal Revenue Service. My experience over these many years has also demonstrated to me that for an internal audit function to be effective, it must be properly implemented by prompt and effective action on the part of operating officials. This, of course, requires a thorough understanding of the internal audit function and its objectives, as well as complete cooperation on the part of operating officials.

"With this in mind, I have been studying our internal audit procedures and the procedures that have been established to assure prompt and effective action to correct deficiencies disclosed by internal audits . . . .

"First, I want to make it perfectly clear to everyone that the primary purpose of our internal audit function is to assist all levels of management in achieving the most efficient administration of the Revenue Service.

"In any organization of 52,000 people mistakes will be made, workload fluctuations will throw work schedules out of kilter, and changing conditions may make policies or procedures ineffective. All of these things require two kinds of action—one is to identify the problem and the other is to take prompt and effective corrective action. Internal audit's function is to identify the problem; however, it has neither the responsibility nor the authority to take corrective action. This is management's responsibility and it is the proper discharge of this responsibility that I want to discuss. For purposes of this discussion I will deal with the operations of our district offices since most of our activities are conducted in these offices. However, the same basic principles apply to those activities that are conducted at the regional level.

"Now, as I see it, in an organization such as we have in the Revenue Service all of the internal audit findings on the audit of a district office should be completely resolved and appropriate corrective action taken at the district or regional level. More specifically, it is the district director's responsibility to take the action necessary to correct the deficiencies and to aggressively follow up to see that his instructions are carried out promptly and effectively. It is the regional commissioner's responsibility to determine that action taken or proposed by the district director is adequate and properly carried through . . . ."

The Advisory Group was of the opinion that the review of technical decisions by those who are not expert has been a contributing factor in the low morale and high turnover in the IRS. It said: "Considering that basically the technical employees of the Service are engaged in difficult and important interpretation of laws, regulations and rulings, and the appraisal of factual situations requiring a high degree of competency, courage, and judgment, it would seem that the efficiency with which they handle their tasks, and the skill, courage, and willingness to assume responsibility which they show, is best appraised in the normal reviewing channels of the Service and not by the same administrative group which handles internal security. It must be expected that, while most employees will accept normal supervision and correction in normal reviewing channels, an employee will not accept gracefully an atmosphere in which his conscientious efforts to do his job to the best of his ability, particularly if the job requires decisions, must be done with the consciousness that an inspector less versed in the particular specialty may challenge his decision.

"We have had reports from different parts of the country of cases which have been closed through normal working routines, through decisions arrived at in the best judgment of those participating (and reviewing) but upset when someone from the Inspection Service has examined the file . . . .

"Every organization employing a number of people must, of necessity, have certain procedures and controls in order to insure the proper functioning of those employees within the framework of the established rules and policies. When, however, the control techniques become of such a character that the employee becomes extremely conscious of their existence, it becomes increasingly difficult to retain many able employees who can easily find posts having a happier working atmosphere. Moreover, employees who will accept such conditions may tend to adjust their mode of operations in order to minimize the impact of those controls on them. The net effect is a normal human tendency to avoid doing anything in which one has to assume the responsibility of justifying his position at some future date."

In addition, the men on the front line, doing the actual audit of taxpayers' returns are, the Advisory Group reports, "placed in a crossfire from above which is damaging to the self-respect and vigor of front line supervisory officials engaged in directing the performance of the work. Inspection Service internal

audits of the Audit Division are designed to insure rigid total compliance with procedures and directives regardless of their practicability. Regional analysts, on the other hand, visit the district audit installations purporting to seek out areas for improvement and helpful modification. District Audit supervisory officials can best satisfy the standards of the Inspection Service if they conduct audit operations as inflexible robots. Conversely, these officials will necessarily be found lacking by regional analysts as to demonstrated versatility, ingenuity and competence in the exercise of judgment and adaptability in coping with actual situations.

The placing of audit activities under regional authority as well as the consolidation of audit activity with others at the district level continues to represent one of the greatest problems attendant to the reorganization of the Internal Revenue Service. The maintenance of this audit activity on a sound and efficient basis is so vital to the fiscal probity of our Nation's economy, to the public's general respect for our Government and to the successful continuation of an effective self-assessment system providing the national revenues, that serious and objective inquiry should continue until adequate corrections or forthright solutions remove all real doubt of the efficiency of this activity."

The whole question of the desirability of separate regional offices is one to which the Advisory Group gave special attention. We will go into that subject in these columns shortly. ☆

New procedural decisions this month

May request reconsideration of sick pay cases. The IRS will reconsider claims for refund because of sick pay income which it rejected because the employer was not commercially insured and will allow such exclusions, following the *Haynes* case in the Supreme Court. This reconsideration procedure will be followed for 1953 and prior years if timely claims were filed; it is now too late to file new claims for these years. *Field Release* 053.

Time to claim refunds of overpayment on tentative return runs from assessment. Due to uncertainty about how its industry should compute income, taxpayer filed only a tentative 1950 return in March of 1951 and paid 30% of its estimated tax then and again in June, 1951. This was a total of $360,000. Its final return, filed in November, 1951, showed tax of only $102,000. In 1953 it agreed to a deficiency of $47,000. The tentative payment of $360,000 was therefore $211,000 too high. In August, 1954, it claimed refund. The Government refused the claim on the ground that the amount had not been paid within three years of the claim. This court orders the refund. Payment with the tentative return is not a payment of *tax*. Until the tax is assessed, it is a mere deposit; the Supreme Court so held in *Rosenman*, 232 U.S. 658. The Government's attempts to distinguish the *Rosenman* case are unsound. True, *Rosenman* had filed no return with the payment, but a tentative return, indeed a final return, is not an assessment. The formal assessment is done by the Commissioner after the return is filed; here it was done in November, 1953. Taxpayer's claim was well within three years of assessment and therefore timely. *Atlantic Mutual Insurance Co.*, DC N. Y., 7/12/57.

Waiver, conditioned on acceptance of compromise, inoperative prior to acceptance. Taxpayer is granted an injunction against the assessment or collection of tax prior to the issuance of the regular 90-day letter. Taxpayer had executed a waiver of restriction, but had added a provision that the waiver was conditioned on the acceptance of an offer in compromise of the tax. The court finds that the waivers were inoperative because the offer was never accepted. Further, the court says that if the waivers themselves are offers in compromise they were never properly accepted. It is beyond the power of the district director to accept a compromise over $500 and if his action is constructed as an acceptance of the offer it must be held illegal. *Steiner*, DC Wisc., 6/20/57.

Can't offset overpayment on joint return against deficiency on separate return. Husband and wife filed a joint return which showed an overpayment. All the income on it was the wife's. The Commissioner is not allowed to offset the overpayment on the 1951 return, which included no income for the husband, against the husband's tax deficiency on a separate return filed for 1944. The taxpayer in 1951 was clearly the wife and the law forbids offsetting one taxpayer's refund against another's deficiency. *Maragon*, Ct. Cls., 7/12/57.

Notice of payment of foreign death taxes a claim for refund. The executrix of the estate seeks a refund for Canadian Succession taxes paid on shares of stock in a Canadian corporation held by decedent. No claim for the credit had been made on the estate tax return. The formal claim for refund was filed two weeks later than the four years allowed after the filing of the original return, and the Commissioner contested the claim on the ground that it had been filed too late. The court holds that the prior filing of a Certificate of Payment of Foreign Death Duty on Form 706CE within the four-year period was sufficient notice to the Commissioner of the estate's intention to file a claim for refund to itself constitute a claim under the applicable statute. Consequently, refund must be allowed. *Winer* DC N. Y., 7/11/57.

EPT 10% post-war refund is "refund" for statute of limitations. If the Government makes an erroneous refund of tax it must begin suit for its recovery within two years. The issuance of 10% post-war refund bonds to taxpayer here was an error and payment of the bonds was refused. Taxpayer brought suit and the Government counterclaimed, showing the error. The court holds the counterclaim is barred by the statute of limitations. The post-war refund has been held to be a refund for this purpose. Since the counterclaim was brought more than two years after payment, it is untimely. *Nelson Specialty Corp.*, DC Calif., 8/6/57.

Returns signed for husband by wife start statute of limitations. Taxpayer, who had been a bus driver and had had little education, began his own bus line. His wife (who divorced him in 1948) kept all the records (nothing more than single entry listings) and they were very inaccurate. He filed no return for 1940; for 1941-1945 she prepared a separate return for him as the business operator and signed his name to it. The court finds that she had authority to sign his name and these returns started the statute of limitations for 1941-1945 since, it finds, there was no fraud involved. For 1940 the deficiency is proper, but only negligence penalties, not fraud,

are assessed. Judge Murdock dissents. He would follow the previous position of the Tax Court that the Regulation requiring a competent taxpayer to sign his own return is valid despite the recent decision by the Fifth Circuit (Miller 237 F.2d 830) that the Code permits signing by an authorized agent. The importance of forcing taxpayers to take responsibility for their returns is shown by cases like this where fraud is charged. In any event, he concludes this taxpayer was not so stupid as to be unaware of consistent understatement—his income as shown by the net worth computations totalled some $209,000 over the five years and only $45,000 was reported. *Booker,* 28 TC No. 91.

Erroneous Tax Court petition serves as informal refund claim. A revenue official found that taxpayer had overpaid his tax, and so advised him on his own initiative. Taxpayer erroneously filed a petition with the Tax Court, but of course the Tax Court has no jurisdiction unless a deficiency is asserted. However, the petition did serve as an informal refund claim, defeating the Commissioner's reliance on the statute of limitations. The court also gives weight to the actual knowledge of the Service that taxpayer was making claim for refund in rejecting the limitations defense. *SoRelle, DC Tex.,* 7/24/57.

Delinquent return filed within 3 years is a timely claim for refund. In October and December, 1955, taxpayer filed delinquent returns for 1951, 1952 and 1953 showing tax due less than withholdings and amounts paid as estimated taxes. Since the latter amounts are presumed to have been paid on March 15th of each of their following years, the IRS rules that a refund of any overpayment of tax for 1951 is barred because the return, which also constitutes a claim, was not filed within three years from the presumptive date of payment, 3/15/52, while the returns for 1952 and 1953 were timely filed within the statutory three-year period and therefore constitute proper refund claims. The Service also points out that the result would be the same under the provisions of the 1954 Code. *Rev. Rul.* 57-354.

Waiver conditioned on closing agreement doesn't stop interest. Interest on a deficiency ordinarily runs until assessment; however, if the taxpayer waives the restrictions on assessment the interest is stopped. However, the Service holds that a waiver condition on execution by the Commissioner of a closing agreement has no effect. It is a nullity until the closing agreement is executed and interest will therefore run to assessment prior to the closing agreement. Should the waiver come after the closing agreement it is meaningless. The particular question rose in connection with a deficiency in personal holding company tax only part of which was eliminated by deficiency dividends (interest on that portion ran until the date of filing the declaration of the claim for deficiency dividends). Interest on the balance would run to the date of assessment unless stopped by the waiver. *Rev. Rul.* 57-305.

Title properly set aside as fraudulently conveyed though no transferee assessment was made. The district court found that transfer of title to certain real estate to taxpayer-wife was a fraudulent conveyance, in that it rendered taxpayer-husband insolvent and unable to pay tax deficiencies and fraud penalties. The wife argued that this was improper because the tax had never been assessed against her as transferee. This court holds that the lower court action was proper. It is true that the tax could not be collected from her as transferee without proper assessment, but such an assessment is not necessary when the action taken by the Commissioner is the recovery of property fraudulently conveyed, not collection of tax. *Payne,* CA-8, 8/8/57.

Procedure for deferring tax during initial military service. Collection of income tax from persons in military service may be deferred if ability to pay is materially reduced because of the service. However, the deferment is allowable for only the initial period of service and upon application. The IRS defines "initial period of service" for draftees, enlisted men, members of a reactivated National Guard unit, and officers, and outlines the procedure for making application for such deferment. *Rev. Proc.* 57-25.

Tax Court can uphold Commissioner though on new theory. Taxpayers were paid certain sums by their controlled corporation which they did not report as income. The Commissioner treated them as taxable dividends. The Tax Court said it was the collection by the corporation of certain receivables lent to the corporation by the taxpayers to serve as collateral for corporate borrowing; and since the taxpayers did not show their basis for the receivables the collection was fully taxable as ordinary income. One Tax Court judge had dissented because this theory had not been presented in the issues. This court holds that if the Commissioner's determination is correct on any theory it should be upheld, and affirms the Tax Court. *Towers,* CA-2, 8/2/57.

Can't sue in district court unless full deficiency is paid. The total deficiency arising when the Commissioner treated certain losses of taxpayer as capital, not ordinary, was some $28,000. He paid about $5,000 and brought suit for refund. Noting a conflict between the Third and Eighth circuits on the question, the district court accepted jurisdiction, and gave a decision on the merits. This court reverses. The Supreme Court has consistently held that full payment of a deficiency is prerequisite to suit in the district court and the legislative history of the Tax Court makes it clear that Congress intended that only in the Tax Court could the taxpayer have his liability adjudicated before full payment. [The Tenth Circuit thus agrees with the Third and is in conflict with the Eighth, which held to the contrary in *Bushmaier (J. W. Myers Estate),* 230 F.2d 146.—*Ed.*] *Flora,* CA-10, 7/1/57.

Tax form showing only net income and tax due not a timely return. Taxpayer received a 30-day extension for filing his 1946 return, and on 4/15/47 signed and filed a blank form containing only a net income figure and the tax due. The court holds such a form fails to qualify as a return, and in the absence of a showing of reasonable cause, sustains the penalty for failure to file a timely return. *Schroeder,* TCM 1957-162.

IRS summoning taxpayer need not show probable cause. The district court properly refused to vacate a summons issued by the Acting District Director to taxpayer to appear, to bring appropriate financial statements and to answer questions about his tax liability. This is an administrative, not a judicial proceeding and the Director is not required to show probable cause of underpayment to justify the commencement of the investigation. *Levine,* CA-2, 3/9/56.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Incidents continue to spark controversy over employment of lawyers by CPAs

SHOULD NON-LAWYERS be forbidden to hire lawyers on a full-time basis? Two recent incidents suggest that an undercurrent of dissatisfaction with such employment exists in the organized bar and among some leaders of the bar. The tender spot seems to be employment of lawyers by non-lawyers who serve the public such as trust companies, accounting firms, etc. This creates a situation in which the non-lawyer employer could, so the charge runs, "retail" legal services, thus (1) putting an intermediary between the lawyer-employee and client, (2) using a non-legal enterprise as a feeder for the rendering of legal services, and (3) in effect undertaking the practice of law by corporations or others not authorized by law to do so.

In the tax field the problem arises mostly in the employment of lawyers by accounting firms. Often these employees have law degrees, or may even be members of the bar, but are not "lawyers" in the sense that they hold themselves out as legal practitioners.

Two recent incidents draw attention to the problem. One, an expression by Dean Erwin Griswold of Harvard Law School suggesting that employment of lawyers on a full-time salaried basis by accounting firms was probably not desirable, and a reply from a national accounting firm which does employ many lawyers. This exchange of views is regarded by many as a substantial contribution to the question.

The other incident is publication in a trade journal of national circulation of a news story reporting the death in committee in the Ohio legislature of a bill sponsored by the Unauthorized Practice of Law Committee of the Ohio State Bar Association which would have dealt with the activities of trust companies in their employment of lawyers. The news story in this publication, attributed to a representative of a banker's group, noted that attorneys supporting the bill "were dissatisfied with the right of trust companies to function in estate planning, to advertise, and to have salaried, full-time attorneys on their staffs; indeed, the whole question of full-time salaried attorneys on the staff of any business or institution could be a principal objective of that campaign."

Your editors checked this story with Merritt W. Green, chairman of the bar committee. Mr. Green indicates that "so far as we know, no one connected with the Committee . . . has claimed, or even implied that a corporation, partnership, or an individual, cannot with propriety, employ a lawyer on a full-time salary basis to do that corporation's, partnership's, or individual's legal work.

"It seems to us that you would have an entirely different situation if corporations and/or other firms which render services for their customers hire a lawyer on a full-time basis to perform services for these customers. It is quite obvious that the lawyer, in this instance, would not be rendering legal services for his employer but would be making it possible for his employer to render legal services for others.

"This, in our opinion, would, in Ohio at least, be the unauthorized practice of law and the lawyer would be in violation of the canons of ethics in more than one respect. This principle, it seems to me, would certainly apply to CPA firms as well as trust companies, insurance companies, collection agencies, etc."

Difficulties when employer is CPA

The difficulties that arise when the lawyer's employer is an accountant was one of the topics discussed by Dean Griswold at the Taxation Section of the ABA summer before last [see 3 JTAX 272]. He expressed the opinion that some of the larger accounting firms were developing something close to the corporate practice of law in using lawyers in their tax departments and engaging in tax planning, making legal suggestions, etc. He went on to say: "This leads to a closely related question which is, I know, a very touchy one. What I have in mind is lawyers working for accounting firms. My own present reaction is that this is an exceedingly doubtful practice. I have not been able to see myself why such employment is not unethical.

"Why does it not amount to solicitation of law business by the lawyer involved? He does not get his own business. The business is obtained by the accounting firm, a lay organization, and is then referred to him. Moreover, the accounting firm charges the client, and the lawyer often receives a salary. Insofar as the lawyer is performing legal services, and is hired because he is a lawyer (and this may well be a proper description of the handling of much tax work) is not such an arrangement a clear violation of the canons of professional ethics? It seems to me that the American Bar Association and the American Institute of Accountants might well look into this situation, and might clarify the present canons, and make it clear and explicit that a lawyer cannot properly be employed as a lawyer by an accounting firm.

"Of course, an accounting firm could hire a lawyer to advise it on its own legal problems. But that is not the situation to which I refer. What I have in mind are lawyers who perform legal services for clients of the accounting firm. This seems to me to be clearly improper, no matter how much indirection may be involved in doing it. This also applies to the legal departments of huge accounting firms, which render legal opinions, and make legal suggestions, and draft papers, for the accounting firm's various local offices. It may be denied that this is done, or that such legal departments exist. No doubt they are not usually called that. I think the whole matter may bear very careful looking into, and the American Institute of Accountants should be as much concerned to look into it as the American Bar Association."

In our next issue [3 JTAX 340], Maurice Stans set forth the position of the American Institute of Certified Public Accountants on the question. "The Institute agrees completely that

no accounting firm should offer to render legal services to its clients or to permit lawyers on its staff to do anything which certified public accountants are not authorized to do. It does not believe that this standard is violated very frequently. Accountants are quite often employed by law firms, and most lawyers agree that they should not be used to render accounting services to clients. Several years ago we proposed to the National Conference of Lawyers and CPAs these mutual propositions. They are still acceptable to the Institute."

Dean Griswold's current view

Recently, in correspondence between Dean Griswold and the CPAs on this subject, published in Vol. 104 *J. of Accountancy* No. 3, p. 29, he again referred to the irritation of lawyers at the increase in the number of attorneys employed by accounting firms.

"In a purely personal and unofficial way," he wrote, "I want to pass on to you a paragraph from a letter which has just come to me from a lawyer friend. I believe it summarizes what is perhaps the really most difficult problem in the lawyer-accountant area. At least, it shows the way some thoughtful lawyers are thinking."

The paragraph read:

"With regard to the CPA item, nothing is surprising in this field. A large accounting firm now has approximately ten lawyers in the 'Tax Department' of its local office alone, having only one approximately three years ago. Another has about 25 lawyers and lawyer-CPAs in its 'Tax Department' and 35 in its 'Auditing Department.' "

How one large firm does it

It happens that the nominee for president of the AICPA is Alvin R. Jennings, of Lybrand, Ross Bros. & Montgomery, who would, of course, be in a good position to speak both for the Institute's point-of-view as well as against a background of practice within a leading accounting firm. Mr. Jennings wrote Dean Griswold, quoting a memorandum prepared by his firm on its policy in hiring lawyers, which said in part:

"The American Institute of Accountants has devoted a great deal of time and effort to finding a workable solution to the controversy over the proper place of the accountant in the field of Federal tax practice.

"Several responsible spokesmen of the bar have asserted that the large national accounting firms maintain legal departments and give legal advice to clients. The AIA has made efforts to find out what, if any, factual basis there may be for such assertions. While these efforts have not disclosed any such cases, they do suggest the possibility that the misunderstanding grows out of the employment of attorneys by accounting firms.

"An example in point may be cited from an article by a prominent member of the bar which appeared last summer in the *Arkansas Law Review* in which the author says: 'A word at this point about the employment of lawyers by accounting firms. While employment of an attorney by the major accounting firms is not per se unlawful, it is evidence that these firms are practicing law in the giving of general advice to clients. This advice not only includes pure tax practice, but in many instances includes a consideration of property and other laws, the consideration of which is necessary to the answer to the particular tax problem. While the employment of the attorney is not itself unlawful, it is what the attorney does for the accountant that is unlawful. The giving of the opinion by the lawyer, acting for the accountant, where the lawyer is simply the employee or agent, is the giving of the opinion by the principal, and not by the agent. This would be true even though the accountant himself, as partner, happens to be also a lawyer. It is the accounting firm, over its letterhead, that purports to answer the questions and to give the advice, and the fact that its agent in giving the advice is a lawyer does not mean that the advice by the firm is thereby legalized. The American Institute should adopt a firm rule that accountants should not, as a matter of policy, employ attorneys. If they do not succeed in this, action should be taken by the American Bar Association.'

"Some of our partners and staff have legal in addition to accounting degrees. In a relatively few cases members of our tax staff who have law degrees are not yet CPAs. These circumstances do not alter the fact that our practice is that of public accounting. We do not practice law and we have no desire to do so.

"Possession of a CPA degree is essential for advancement to positions of responsibility in our profession. Accordingly, our personnel policies stress the importance of attaining the degree. This is so without regard to whether the staff member may be employed in the auditing, special management or tax areas of our practice. At no point should we require that the possession of a law degree be a requisite for employment or advancement. Possession of a law degree, on the other hand, should not prevent us from employing anyone who has the requisite accounting education or experience.

No identification as lawyers

"To avoid the unwarranted implication that we are holding ourselves out as competent to practice other than in the field of public accounting, our Executive Committee believes that we should not approve any public reference to law degrees which may be held by partners or staff. Articles written or talks given by partners or staff members who possess dual degrees may properly describe the author as a CPA but should not identify him as a member of the bar. If a member of the staff should publish an article, or appear on a program, his identification with the firm may be stated but no reference to a legal degree, if any, should be approved." ☆

Tax Institute to study differences in tax burdens

WHAT are the consequences of special tax privileges for one type of taxpayer, or one type of income, compared to others? The Tax Institute will devote its annual meeting (Princeton, N. J., November 21 and 22) to this subject this year. Many well-known tax men are scheduled to speak on various aspects of this question.

The revenue and administrative costs of tax differentials will be considered by Dr. Dan Throop Smith, Deputy to the Secretary of the Treasury. Professor Stanley S. Surrey, of the Law School of Harvard University, will discuss the tax base for individuals.

The effects of tax differentials on investment will be discussed from the viewpoint of the corporation by William J. Casey.

Tax differentials in executive compensation will be examined by Robert A. Schulman, Wenchel, Schulman & Manning, Washington, D. C.; in compensation for workers by Peter Henle, Assistant Director of Research, AFL-CIO; and in compensation for artists and inventors by Jacquin D. Bierman, J. K. Lasser & Company. ☆

Cost-finding in a law office: how to determine what it costs to do a job

by **RALPH R. NEUHOFF**

Fee-setting is one of the most touchy aspects of tax practice; most tax men confess to much worry and uncertainty about it. But the better your knowledge of what it costs to do the job, the easier it is to set fees and the easier to defend them if any questions come from the client. In this, the second of two articles, Mr. Neuhoff warns against inventing trick systems. He suggests how to break down and keep track of items of cost; how to budget income and expense, and especially how to be sure all items of cost are included in determining charges to clients.

COST-FINDING in a law office is simply an application of business or industrial accounting to the law office as a guide for charging for legal services. We don't invent anything and we don't originate anything; we simply adopt time-honored methods which industry has spent thousands of dollars to develop. What we obtain is simply pertinent information. It is not controlling and need not be a straitjacket to the office which adopts it.

Sources of information on cost-accounting consist of books and articles which have been written and published on the subject, the proceedings of the meetings of the National Association of Cost Accountants and the published bulletins of that Association. Also the services of a public accountant may be very helpful.

Considering particularly the subject of cost-accounting, we should emphasize in the first place that there is no such thing as a "true" cost. This statement is applicable to all cost-accounting, not merely cost-accounting in a law office. What we call "cost" is merely an arithmetical result based on certain assumptions. With other assumptions you would have a different cost. Therefore, we can say that cost-accounting is an art rather than a science. This art consists of "the selection of certain assumptions and procedures deemed likely to result in answers usable for the purpose intended, on a basis which does not entail an expenditure of effort disproportionate to the result to be achieved." Let us look at the parts of the above definition. It will be seen that we are to: (a) select assumptions, (b) select procedures, (c) in order to get usable answers, (d) without disproportionate effort. Therefore, successful cost-accounting will be a compromise between elaborateness and expediency. It will call for some mechanical computations, and these should be done mechanically.

In order to introduce the subject of cost-accounting, let us consider how it would be if you could wait until the end of the year to calculate your cost. Assuming the simplest case of a one-man and one-girl office, after the year closed, you could say what it cost you to be in business. This would be determined by the record of your actual expenditures for such things as rent, salary of the stenographer, office supplies, etc. You could also suggest an appropriate salary for yourself. This is not what you would "like" to make. It is to be the amount of compensation which you think would be commanded by a lawyer to perform the work which you had done during that year, assuming that such a lawyer could be obtained on a salaried basis.

After you had ascertained the expense of being in business and had hit upon an appropriate salary for yourself, you could add these together and then allocate the sum total, on some fair basis, to the work which had been done. That is, you could do this if you remembered the work in sufficient detail. You could then send out bills based on the year's services.

The preceding plan has some very obvious flaws. For example, there would be a delay in billing which might result in some clients not paying at all. Furthermore, you would have to finance yourself during the year. All in all, we would say that this procedure would be quite impractical.

How can we correct these flaws? For one thing, we can predict the expenses *in advance*. This is called a budget, but since the term "budget" is in disfavor in some circles, let us call it "proposed expenses." Also you could predict your own salary. This is to be simply an evaluation and not a prognostication. It is the amount which an employee would command to do the professional part of the work of the law office.

You might also endeavor to predict the work to be done in the year, but this would be much more difficult. Therefore, let us substitute a prediction of how many hours will be spent on professional work during the year. This would, of course, have to be estimated for the first year, or you might have a "trial run" for a month in order to determine what the probable time would be per month. Having in some manner estimated the number of hours of professional work which are expected to be performed in the year, it would be possible to divide the total expenses and salary by this number of hours in order to arrive at an hourly rate.

It will be seen that in most situations this rate could hardly be used to set fees, in disregard of all other considerations. It may nevertheless be a valuable guide, for this reason: because of the way in which it was arrived at, if you could charge an *average* of that amount for as many hours as you have estimated, you would produce or "recover" the total amount which you set out to recover. This is not the counsel of perfection—it is quite possible to do.

However, concerning expenses, there are refinements which could, and probably should, be introduced. For example, if you have more than one lawyer in the office and one of these lawyers spends more time on administration, such as the sending out of bills, hiring of help, some allowance should be made for this time. This should be treated as expense in the cost system. Remember that we are not tying our cost system into our bookkeeping; therefore, the question of whether any allowance is actually paid for this time would be irrelevant so far as the cost system is concerned.

In like manner, we can allow interest on capital invested. This is another item which is not paid out as such, but it is a valid charge on the cost system. If, for example, you have charged to expense on your income tax all capital items when bought, you will have on the books no investment for equipment. Yet you nevertheless have invested capital for cost-accounting purposes. Probably

[*Mr. Neuhoff, a St. Louis, Missouri attorney, and a member of the faculty of Washington University School of Law, discussed in these columns last month filing and record-keeping systems. Both articles are based on an address before the Arkansas Bar Association*].

you will have a library, and you may have a very extensive one representing a considerable investment of money. Probably you maintain a cash balance in the bank at all times for firm purposes. Interest on all the capital invested should be allowed in the cost system.

One may wish to differentiate between expenses applicable to juniors and seniors. This should, however, not be a subsidy. Even though you may find that it costs money to train a junior and the cost system shows that you are losing money on the junior each year, it is better to let the cost system show this than to juggle the figures in what amounts to a subsidy.

We referred previously to the "salary" component of our cost figure. With respect to salaried lawyers, if there is an actual salary paid, this figure may be used. On the other hand, with profit-sharing lawyers, either the sole proprietor or a partner, it is necessary to assume a salary by an estimate as indicated above. We would not recommend using the drawing account as the salary component, although that has been done in some published systems. The drawing account should be a much more modest figure. There are further refinements as to the hourly charge which you may desire to introduce. For example, so far we have merely an over-all average rate for each lawyer separately.

Payment for risk

So far we have not introduced any adjustment for risk assumed. On the other hand, everyone who is in business assumes some risk. In fact, business has been defined as the assumption of risks with a view to profit. It may be ignored in a one-man office, but if there are clerks and juniors who must be paid salaries, this will take a capital fund. The adjustment for risk assumed is analogous to the return on risk capital in an industrial concern. Again, it is not necessary to treat it the same way on your financial accounting, even though you include it in your cost figures. It should be recognized, however, that this is not true "cost," but is "profit." It is axiomatic that cost should not include profit. This item should be identified so that it can be segregated from "cost" and scrapped if necessary.

Some allowance must be made for variance in the value of work which is performed. In our discussion thus far, we have implicitly taken for granted, so far as our figures were concerned, that all work is of equal value, but we know that such would not be the case. It is, therefore, suggested that we add a "margin markup" in order to arrive at a top figure which will be susceptible of reduction in those cases where the work does not justify that top figure. This is on the theory that, psychologically, it is better to "discount from" than to "add to." The purpose is to allow room for reduction where the indicated cost exceeds the value of the services appraised in the light of other considerations. This is called "voluntary reduction" as a bit of wry humor, but it is anything but voluntary. The amount of the margin markup is a matter of judgment.

Assuming that we have made all of these adjustments and that we have collected these figures on cards in some routine manner, we will have cards showing hours and a monetary amount which will indicate cost plus allowance for risk, plus margin markup rather than bare cost.

If you have succeeded in getting this figure on all of your work, you will have an automatic profit over and above the professional salaries. In such event it might be well to scrap your cost system before it cramps your style. However, most people will find that they must deviate from their figure as shown on the card, and their objective should be to arrive at the average recovery which the cost system is set up to obtain.

It will still be necessary to collect, as we have indicated before, data concerning the number of hours performed on the various jobs. It is advisable to determine the number of hours performed by daily reports by the lawyers on the separate projects. There are various methods of making these reports. However these reports are made, the time should be ultimately posted to job tickets. The job ticket might represent a single task, such as a will or a lawsuit, or it might be all of the work during the preceding three months or during the preceding six months. The job-ticket series preferably should not be the same as the file-system series. Reporting is accomplished by rough notes during the day, summarized on a report after the day is closed and tabulated on cards or pages.

Let us consider how in actual practice this system may be applied. Possibly the rate indicated on your card, adjusted as it is for "margin markup," will be a satisfactory practical top where time is a function of the charge. Where time is not a function of the charge, for example in a contingent case or highly successful matters, it still serves as an index of the profitableness of the work. It indicates whether the operations are producing a profit or not.

In most instances, however, time will be a function of the charge, that is both you and your client will be desirous of letting the amount of time spent on the work bear a considerable relation to the fee charged. With a large-retainer client, the total indicated "cost" on a time basis may be practically determinative of the charge to be made.

In many instances, the amount of the fee will be arrived at by negotiation after the work has been performed. Here it is a great advantage to the lawyer to be able to point to an impersonal system, applied uniformly to all clients for the purpose of indicating what a fair charge would be. Once you have convinced a client that he is being treated the same as everyone else, you will have gone a long way in convincing him of the proprietary of the charge suggested.

While the matter will not be discussed here, a cost system such as is described can also be utilized in a "merit plan" which will be some indication of the respective values of the various partners.

Conclusion

In conclusion, we have stated that a law office, large or small, resembles general business, so that management is best learned from general business, where you get expert treatment of the problems. The systems devised by lawyers which were improvised may show great ingenuity and even invention of a minor sort, but they should be avoided like the plague. We have limited our discussion to the following three fields: (1) files, (2) bookkeeping and (3) cost-accounting. For all of these we have found that industry furnishes the best guidance. We have also mentioned some specific devices, shortcuts and expedients not necessarily as recommendations to be adopted, but as examples. What can you do about it? First you may adopt the

attitude that "my business is different." This is an easy out, but not advisable. It is better to find out wherein your business is the same as or resembles other businesses and to consult the vast mass of data accumulated by industry with respect to office management and cost-accounting. Many years ago there was a famous talk delivered thousands of times entitled, "Acres of Diamonds." The message of the talk was that in the life of everyone there are numerous unseen opportunities and potentialities which the speaker called "acres of diamonds." And this is the thought that I wish to leave with you: Industry has worked out its own management problems. Your management problems are essentially the same. You have within your grasp "acres of diamonds." All you have to do is to reach out and use them. ☆

Fairleigh Dickinson Tax Forum to be held Nov. 9

THE FAIRLEIGH DICKINSON University 4th Annual Tax Forum on Federal income taxation and New Jersey state taxation will be an all-day session Saturday, November 9. It will be under the direction of Harold Feldman, Dean of the University's School of Business Administration. Guest speakers will be Alfred Chamberlin, IRS Regional Commissioner from Philadelphia, and Aaron K. Neeld, N. J. State Treasurer.

Tax course on records now available

A SERIES of phonograph records, described by their producers as a "complete professional Federal tax course on records" is now being marketed by Tax Lectures on Records, Inc. The set consists of 20 double-sided 12-inch records, one hour each, 33⅓ rpm. A wide variety of subjects is covered. Lectures are prepared by some thirty practitioners, most of them names familiar to tax men. Each set of records has printed outlines to accompany each lecture. Price for the set complete is $85 plus postage. ☆

Tax Forum dinner Nov. 21

THE ANNUAL dinner of the Federal Tax Forum, Inc., will be held November 21 at the Hotel Biltmore, New York City. The Hon. Justin F. Winkle, Assistant Commissioner of Internal Revenue, will be guest of honor.

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NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Tax problems in allocation and subsidies: how the shipping industry solves them

by H. MAURICE FRIDLUND

Occasionally an expert in a particular area of taxation will take the time and trouble to set down some of his conclusions after years of experience. When he is a good writer and a clear thinker, his exposition makes even the most abstruse problems seem clear. Mr. Fridlund, known for his mastery of the problems of the shipping industry, prepared with meticulous scholarship an extensively footnoted paper for the Tulane Tax Institute. The following discussion is adapted with his approval to bring out points of interest to tax men who may not be familiar with all the problems involved, and to emphasize points of general usefulness.

BY THE VERY NATURE of its business, the shipping company is obliged to transact its business in many jurisdictions, each with its own set of tax laws. If an American manufacturer finds it advantageous to enter a foreign country, he usually can limit his exposure to its tax laws by operating through a domestic or foreign subsidiary or through an agent or factor. The shipping company seldom has any such convenient alternatives. When it sends its ships to a foreign port, the shipowner itself is doing business in that country, and its local subsidiaries or agents are apt to furnish only a limited insulation.

The basic problem is: What part of a vessel's earnings are taxable in a given country? Of course, the vessel's home country can and usually does tax all of its earnings. But what about the foreign country? The problem is not an easy one, and there is no universally accepted basis for computing the earnings of a ship in a foreign country. Each country has its own formula, and the aggregate of the foreign taxable incomes could exceed the actual income.

The problem is perhaps best illustrated by its history in the United States. Since the inception of our income tax laws, we have purported to tax a foreign company only on its income "from sources within the United States." As applied to, say, a British steamship line operating between Liverpool and New York City, how much of the net income from such round voyages is "derived from sources within the United States"? Originally, our Treasury Department held that the freight and passage monies on the portion of a voyage outbound from the United States, constituted gross income. In other words, the net income of the outbound voyage was the taxable income on the theory that its revenues originated in the United States, and the income from the inbound voyage was ignored. This ruling was contained in the famous Treasury Decision 3111. Then came World War I, when the great bulk of shipping was outbound from this country, and foreign shipping companies sometimes sent their ships here in ballast (at a loss on the inbound voyage) in order to earn handsome outbound freights. Here the formula broke down as it frequently resulted in taxing a ship here on 125% or more of its actual income from the round voyage.

U. S. rule on source of income

At this point, the Treasury Department admitted error, and called in nationally known economists to solve the problem. It was recognized that a shipowner was doing business in this country on the inbound, as well as the outbound, portion of the voyage, but his income here was only some fractional part of the round voyage's profits, as the major part thereof was undoubtedly earned by transportation on the high seas. The theory that emerged (T.D. 3387) was that a shipowner earned income in this country by soliciting business here, loading or unloading cargo here, by keeping his ship in American ports for these purposes, and by carrying the cargo in or out through American territorial waters. If the gross income from American sources could not be computed directly, the local expenses could be ascertained and their ratio to the round voyage expenses computed, and this ratio applied to the round voyage's net income would give the taxable net income "from sources within the United States." In this expense ratio, three factors were recognized: (a) direct allocation (such as expenses for cargo solicitation, stevedoring, docking, pilotage and port charges); (b) mileage allocation (for expenses such as fuel, oil and repairs), and (c) time allocation (for expenses such as crew's wages, insurance and depreciation). The resulting ratio is applied to the round voyage gross and the U. S. allocated expenses are deducted to give the U. S. voyage net income, from which general expenses (such as overhead) are deducted.

As can readily be seen, the formula of T.D., 3387 which has been embodied in subsequent Revenue Acts and Regulations, is based on the economists' theory of perfection, but results in tax computations that are incredibly complicated because the allocation formula must be applied separately to each American port touched by each voyage. Further, an error in any one step of the formula affects the computation in every subsequent step. Nevertheless, this is the basic formula that the American law prescribes for determining income "derived from sources within the United States" in the face of foreign-flag ships trading to our ports. Except as superseded by international arrangements for reciprocal exemption of shipping income, the formula with all its complications still governs the computation of a foreign-flag ship's taxable earnings from American sources.

The sad part of it is that, as a practical matter, the complications are quite

unnecessary. Obviously, the longer the voyage in time and distance, the smaller will be the percentage of its round voyage income that is allocable for taxation in the United States. The author has found that normally the percentage so allocable to round voyages on the principal maritime trade routes of the world from the United States are approximately as follows: (a) North Europe 10% to 12%, (b) Mediterranean ports 9% to 11%, (c) South American 7% to 9%, (d) South Africa 6% to 8%, and (e) Far East 5% to 7%. In recognition of the inevitable mathematic conclusions, the Treasury auditors have from time to time shown a disposition to accept returns which fall within the foregoing percentages of allocation.

Foreign rules

If we in this country, with our well developed tax theories (and perhaps a penchant for theoretical perfection), have had trouble in determining how much of a foreign ship's income to tax here, you can imagine the heterogeneous sets of rules that pertain in certain foreign countries. None of them recognizes what is implicit in our T.D. 3387, namely, that the great bulk of inbound and outbound ship revenues are earned on the high seas or abroad. Most of these foreign countries still adhere to some variant of the extraterritorial taxation theories inherent in our discarded T.D. 3111, namely, that revenues originating in that country are taxable by it. Some other countries have found that it is impractical to determine how much of a foreign-flag ship's income and expenses are allocable to any particular port, and have decided to cut the Gordian knot by prescribing an empirical formula. These formulae, however, create serious tax problems for an American shipping concern in foreign countries. Fortunately, the problems are gradually being resolved by extensions of the principles of reciprocal exemption.

U. S. tax credit

Meanwhile the impact of foreign taxation on American taxpayers is softened by the credits allowable against the U. S. tax for "income, war profits and excess profits taxes" imposed by "any foreign country." In general, the U. S. tax can be reduced by any foreign tax, with the limitation that the credit for any foreign country's tax shall not exceed such portion of the U. S. tax (before credit) as the taxpayer's "taxable income from sources within such country" bears to the taxpayer's entire taxable income. Though intended to limit foreign tax credit to a rate comparable to the effective U. S. tax rate, this clause raises the old problem of what is the income from "sources within" such country. Obviously, it would be unfair to impose the American rule of determining sources, when the foreign country uses a different rule based on concepts of origin or economic incidence. In other words, when the economic effect of a foreign tax is a rate lower than the U. S. tax rate, the manner of computation of the foreign income should not furnish an excuse to deny the U. S. tax credit. Particularly is this so, since under our present Code the credit for foreign taxes extends to those "generally imposed" by a foreign country "in lieu" of a tax on income or profits. The latter provision eliminates the Treasury Department's former objection that a foreign tax based on a portion of the gross income or revenue cannot be deemed tax on income or profits.

Reciprocal tax exemptions

As already intimated, the maritime nations are gradually adopting arrangements for reciprocal exemptions of each other's shipping. In view of the difficulties of determining taxable income of foreign shipping and the diverse formulae prevailing in the various countries, reciprocal exemption commends itself as being both practical and just. Its net effect is to leave taxation of shipping to the country of the ship's flag or of the shipowner's domicile.

Actually there are two kinds of reciprocal exemptions, one a unilateral declaration of conditional law and the other arising from a bilateral agreement. Frequently, these two approaches differ in their results because they lay down different conditions.

Our Internal Revenue Code provides that there shall be excluded from gross income of a foreign citizen or corporation and exempted from U. S. taxation "earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption" to American citizens and American corporations. It will be noted that this provision places emphasis on two points: (a) The earnings must be derived from the *operation* of a foreign ship and (b) The law of that *ship's flag* must grant an equivalent exemption to U. S. citizens and corporations.

Some rather interesting results flow from these provisions. Of course, the taxpayer in question must be a foreign citizen or a foreign corporation. The exemption is not limited, however, to the owner of the ship, but extends to the charterer who hires the ship from the owner and operates it in the American trade. Further, if the law of the ship's flag grants an equivalent exemption, her earnings in this country are exempt, regardless of whether any similar exemption is granted by the law of the country in which the ship's owner or charterer is domiciled. For example, Cuba does not grant an equivalent exemption, but Panama does. Nevertheless a Cuban corporation may obtain the U. S. exemption on the earnings of a Panama-flag vessel, which the Cuban corporation owns or charters. Conversely, a Panama corporation cannot obtain the U. S. exemption in respect of the earnings derived here from its operation of a Cuban ship.

Since the equivalent exemption is in the nature of an international agreement, the provision is construed liberally, instead of narrowly as in the case of most exemptions. As a result, the exemption is accorded to a qualified ship's earnings, and is extended to bank interest on freight monies collected and kept here, pending payment of the ship's disbursements and remittance home of the balance.

As mentioned above, our "equivalent exemption" is a unilateral provision based on a condition to be fulfilled by the laws of the foreign ship's flag. The foreign country is not required to agree that it will continue to exempt American ships' earnings. Consequently, whenever that foreign country passes a new tax law, the question arises anew as to whether that country continues to fulfill the conditions for the equivalent exemption. Although our law on the point has retained the identical provisions on the point for some thirty-five years, it is not safe to assume that, because a certain foreign country has once been held to qualify for the equivalent exemption, it necessarily continues to so qualify. In cases where Executive Agreements have been concluded between the United States and a foreign country, recognizing that it satisfies the equivalent exemption provisions, it may generally be assumed that such status is a continuing one.

[*H. Maurice Fridlund is a member of the New York law firm of Kirlin, Campbell & Keating.*]

The second form of reciprocal exemption for shipping is contained in various tax treaties or tax conventions between the United States and certain foreign countries. This kind of exemption is, of course, bilateral in nature, as the two countries agree to exempt each other's ship's earnings. The provisions of these agreements are not uniform and their approaches to the problem vary considerably. Three different types can be distinguished:

1. The *first* type is a treaty or convention which provides that citizens and corporations of one country are exempt in the other country on earnings of ships documented under the laws of his or its own country. Here a double test is prescribed: that both the residence of the owner, *and* the documentation of the ship must be in that country.

2. The *second* type is a treaty or convention providing reciprocal exemption to citizens or corporations of the other country, with respect to earnings of ships which are either documented in his own country or in any third country which grants such exemption to shipping enterprises of both contracting countries. Here there is also a double test, but the ship's flag need not be that of the operator's nationality.

3. The *third* type is a treaty or convention which broadly provides reciprocal exemption to a resident or corporation of the other country. Here the ship's flag is immaterial, and the vessel might be documented in a third country which does not grant exemption to either nationals or ships of either of the contracting countries. It is interesting to note that these tax treaties which take *citizenship* of the operator as the sole test, are the converse of our statutory exemption which takes the ship's flag as the sole test.

An interesting problem will some day arise as to whether the more restrictive provisions of a tax treaty or convention will prevail over the broader terms of the equivalent exemption under our Internal Revenue Code. Suppose, for example, that a Netherlands corporation operates a Panama-flag ship to the United States. The United States-Netherlands tax convention of 1948 provides for the double test, that both the residence of the operator and the documentation of the ship shall be in the Netherlands. However, Panama satisfies the equivalent exemption of our Internal Revenue Code of 1954, under which Panama-flag ships are exempt here regardless of the nationality of the operator. Under these circumstances, is the Netherlands corporation operating a Panama-flag ship exempt on its earnings? The technical rule that the latest enactment (statute or treaty) prevails, is not applicable as the Code does not apply where its application would be "contrary to any treaty obligation." Where the two provisions are not necessarily inconsistent, there is no reason why both exemptions should not be applied. The usual rule that exemptions shall be construed *strictissimi juris* is not applicable since we are concerned with international relations, where a liberal construction is required.

There is no doubt that the "reciprocal exemption" provisions have eliminated many complicated, annoying and burdensome tax problems that formerly afflicted international shipping, and that the American Merchant Marine has shared in these benefits. As between the United States and some of the great powers, for example, Great Britain, there is an adequate *quid pro quo*, even if British ship operators are relieved of more American taxes than American ship operators are relieved of British taxes. At least, these two countries are comparable both in their intertrading tonnages and in their tax rates. The question is sometimes raised, however, whether the United States benefits from reciprocal exemption arrangements with foreign countries, where there is a great disparity in either of these two elements. Unfortunately, the discussions of this question frequently generate more heat than light. Too often it is forgotten that the taxes which this country can collect from foreign flag ships are relatively small, whereas the taxes which a foreign country can collect from American ships may be substantial. Further, if two foreign countries reciprocally exempt each other's ship earnings, but both tax our shipping, the American-flag ships are placed under a double handicap. Actually the extensions of reciprocal exemptions between the United States and foreign countries have helped to keep alive the American Merchant Marine. The reason why, at various times in our history, the American flag has almost disappeared from the high seas is that we have been unwilling to enable our ships to compete on equal terms with foreign ships.

Tax treatment of subsidies

Not until the Merchant Marine Act of 1936 was a consistent and logical plan evolved, which provided for equalization of costs between American-flag and competing foreign-flag operations. Such equalization was extended in four directions: (a) a "construction differential" to absorb the difference in cost of building the ship here and abroad; (b) the absorption by the Government of national defense features built into the ship; (c) an "operating differential" to equal some of the excess operating costs under the American flag, as compared with those on actually competing foreign ships, and (d) a tax exemption for earnings required to be plowed back for replacement of old ships and building of new ships. We are here concerned with the tax effects and tax problems generated by these provisions, but a brief background of the Act's requirements is a *sine qua non* for comprehension of the tax aspects.

First, consider the construction differential, which is actually a subsidy to the American shipbuilding industry. At any rate, the differential is not a subsidy to the shipowner, nor is it taxable income to him. Furthermore, the Government is not making a gift to the shipowner of the construction differential, which is granted on several express statutory conditions. One is that the vessel must remain under the American flag and operate on American routes. Another is that in time of war or other national emergency, the Government may requisition the vessel either (a) for *title* at its depreciated cost to the owner, or (b) for *use* on a similar basis. In this way, the Government avoids payment of the appreciated wartime value as required by the Constitutional requirement of "just compensation." Unfortunately, the machinery for determining the construction differential has been defective, to say the least. Even when a contract has been signed between the Government and the shipowner, fixing the construction differential, it has been the subject of dispute and adjustment long after the vessel has been delivered and is operating. With recent improvements in procedure, however, it is hoped that the shipowner no longer will be compelled to guess at the cost basis of his ship and the proper deductions for its depreciation.

The "operating differential" is called a "subsidy," even in the 1936 Act. Actually, it is a payment made pursuant to a contract, whereby the shipowner undertakes several arduous obligations. He must operate the vessel on a prescribed "essential trade route," in good times and bad, with a given number of voyages per year to give adequate service. He must employ American crews, buy his supplies from American sources, repay the so-called "subsidy" if his earnings exceed a statutory maximum, devote a portion of his earnings and profits to build new ships, restrict his dividends and officers' salaries, and conform to certain regulations by the Maritime Administration.

Meanwhile, his operating differential payments are included in his taxable net income. There is a question, however, whether such payments should be included in his gross income or applied to reduce his deductible expenses. So far as United States taxation is concerned, either theory will produce the same net income. When we come to foreign and state taxation, it makes a difference. Particularly in those foreign countries which tax American ships on some portion of their gross revenue, the question arises whether such figure shall include or exclude the Government operating differential subsidy. While the question has not been fully settled, the better practice and the one which is consonant with the philosophy of the 1936 Act is to exclude the subsidy from the gross revenue. Sometimes the same question arises in state taxation which is based in whole or in part on the factor of gross revenue.

Statutory reserve funds

Some of the most interesting and difficult tax problems of the American Merchant Marine are those relating to deposits in and withdrawals from the various statutory Reserve Funds. In this regard the problems of the non-subsidized companies are relatively simple, as their use of the statutory provisions is a matter of election. In the case of the subsidized lines, however, their compliance with the reserve fund provisions is largely mandatory.

Non-subsidized companies may elect to make use of two statutory fund provisions.

The replacement fund long permitted under the Internal Revenue Codes is well known and available to all taxpayers in connection with "involuntary conversions." If a ship is sunk, destroyed or requisitioned, the profit realized on her insurances or other indemnity is not recognized, provided the owner elects to apply the proceeds to the acquisition of a replacement vessel. If he so elects, it is good practice to set up a replacement fund on his books, although such fund has not been required by the statute since 1951. After such election, the shipowner must obtain from the Treasury Department an adequate time allowance to make the replacement, as in the case of a ship the "one year" primarily allowed will seldom be sufficient. The real problem, however, will be whether the owner should elect the involuntary conversion provisions in the first place, since in that case his cost basis of the replacement vessel will not include the nonrecognized profit. It may be decidedly to his advantage to pay his 25% capital gains tax and have the benefit of the full cost basis of the replacement vessel, whose extra depreciation will ordinarily be worth 52%, and perhaps up to 95% in periods of excess profits taxes. Generally speaking, if the conversion profits are relatively small or the future tax rates promise to be relatively high, the taxpayer cannot afford to elect the nonrecognition benefits of the involuntary conversion provisions.

The construction reserve fund provisions of the Merchant Marine Act are somewhat similar in purpose, except that they apply only to American ships and include the case of a voluntary sale as well as an involuntary conversion. The requirements for nonrecognition of the profit are more onerous, however, in that the proceeds must be deposited under control of the Maritime Administration in the "Construction Reserve Fund." Such fund can be applied to the construction or acquisition of a new vessel or, with the approval of the Secretary of Commerce, to the reconstruction or reconditioning of, or the payment of mortgage on a relatively new vessel. The rules for deposits in and withdrawals from such fund are prescribed by joint regulations of the United States Maritime Commission and the Commissioner of Internal Revenue. Those regulations contemplate in general a modified "first-in, first-out" arrangement, which becomes important since the shipowner may deposit in a single fund the proceeds of several vessels sold or converted on different dates. In actual practice, however, the construction reserve fund provisions have not proved attractive and have not been used extensively.

The trade-in provisions are in a sense a statutory reserve fund. Any American vessel which is at least 12 years old (until July 1, 1958, a tanker ten years old) and which is obsolete or inadequate, may be traded to the Federal Maritime Board for a "credit" against the construction of a new vessel. With certain exceptions, the trade-in allowance is at a "fair and reasonable value" determined by the Board. No gain is recognized on the exchange, the new vessel taking the cost basis of the old, increased by any additional costs in excess of the credit and decreased by any loss recognized.

Subsidized companies' tax problems center in a large measure around the provisions pertaining to their statutory reserve funds into which regular deposits must be made both on account of the capital and earnings of subsidized vessels.

Into the capital reserve fund must be deposited the annual ship depreciation (if earned) and the proceeds of all insurance indemnities for vessels lost and of all sales of vessels. This fund is dedicated to replacing and paying for the existing ships and to the acquisition of additional ships, directly or indirectly, and it can be used for no other purposes. Withdrawals cannot be made without the countersignature of the Maritime Board.

Into the special reserve fund must be deposited annually all earnings of subsidized vessels in excess of 10% of the "capital necessarily employed." At the end of each ten-year period, half of such deposited earnings must be applied toward "recapture" of the operating subsidy received, and the balance theoretically may be "withdrawn" by the contractor for its general corporate purposes.

In addition to these "mandatory deposits," the operator may also make additional "voluntary deposits" of earnings or profits, in either reserve fund, but only with the "approval" of the Federal Maritime Board.

Agreement on taxation of reserves

Since it is impossible both to deposit earnings and profits and also to pay taxes thereon, the Act provides for certain tax benefits. The famous Section 607(h) of the 1936 Act provides: "The *earnings* of any contractor *receiving* an

operating differential subsidy, . . . which are deposited in the contractor's reserve funds . . . shall be *exempt* from all Federal taxes," except that "earnings *withdrawn* from the special reserve funds and paid into the contractor's general funds" shall be *"taxed* as if earned during the year of withdrawal." [Emphasis supplied.]

The pattern behind this provision seemed reasonably clear. Earnings deposited in a reserve fund became conditionally tax-exempt. If the deposit was applied to an intended purpose (such as purchasing a new ship), the inchoate exemption matured into a permanent one; but, if a deposit was withdrawn into the contractor's general funds, it became taxable in the year of such withdrawal. Of course, the tax exemption applied only in the year that the contractor was "receiving" an operating subsidy.

The Treasury Department, with its traditional hostility to any tax exemption, challenged the foregoing concept and held (a) that the term "exempt" does not permit a conditional tax exemption, but only a tax deferment, and (b) that the term "earnings" referred only to ordinary income and did not include capital gains. Under such interpretation, the capital gains realized on the sale or insured loss of a ship would be taxable, despite the mandatory deposit of the entire proceeds in the capital reserve fund. It also meant that operating income, deposited in the special reserve fund and then reinvested in a new ship, would not be included in the depreciable cost basis of such ship.

Rather than litigate the issues, the subsidized lines compromised with the Treasury Department, and, under the aegis of the House Merchant Marine and Fisheries Committee, concluded a closing agreement with the Treasury in July of 1947. Therein it was recognized that the tax benefits under Section 607(h) did not apply during the war years (1943-1945) when the operators were not "receiving" an operating subsidy. The tax benefits were recognized as applicable both to ordinary income and capital gains. As to the pre-war years (1942 and prior), the deposits were held to be "exempt," but as to the post-war years (1946 and subsequent) the deposits were held to be merely "tax-deferred." Illogical as that closing agreement may seem, it has furnished a workable basis for determining the tax consequences of deposits in the reserve funds, as well as the subsequent applications of and withdrawals from such reserve funds. The fact is that the closing agreement, together with the Interpretative Bulletin issued to explain, has furnished such a complete code that relatively few tax problems have arisen which could not be solved thereunder.

In practical effect, it makes little difference whether the deposits are treated as tax-exempt or tax-deferred. So far as "withdrawals" from the reserve funds are concerned, the tax thereon is the same whether in the interim the deposits are considered temporarily exempt or tax-deferred. It is true that the tax basis for a ship purchased entirely with tax-deferred funds would be zero, and hence under the Internal Revenue Code no depreciation on such ship would be allowable, and her entire sales or insurance proceeds would constitute capital gain. Again this is immaterial, so long as the company's subsidized status continues under the Merchant Marine Act of 1936, because it requires deposits for the vessel's depreciation based on actual cost, and also deposits of her entire sales or insurance proceeds. So long as the deposits continue to be tax-deferred, the net result is almost the same as if they were tax-exempt. In practical effect, therefore, the Treasury's misinterpretation of the statutory term "exempt" has not produced any great hardships.

Recapture

As already mentioned, at the end of each ten-year period, the Government is entitled to "recapture" the operating subsidy from 50% of the mandatory deposits in the Special Reserve Fund. Consequently, the Maritime Administration makes detailed audits of a subsidized line's annual accounts in order to determine the proper amount of the operating-differential subsidy and the portion of the total subsidized income required to be deposited. All too frequently, such audits are not finalized until long after the lapse of the ten-year recapture period. In the meantime, the company either must keep open its Federal income tax returns, or risk a major increase of its mandatory deposit requirements after the statute of limitations has barred a claim for tax-deferment therefor.

This situation would be bad enough if the Treasury Department and the Maritime Administration employed the same accounting methods, but they do not. If the company litigates a matter of income or expense relating to its subsidized operations for (say) 1950 and the issue is finally decided in 1956, such additional income or expense would accrue in 1956 for income tax purposes, but for Maritime accounting purposes it would be thrown back to 1950. If, as a result of this adjustment, Maritime calls for an additional mandatory deposit for 1950, after the tax return for that year had been closed, one might think that this would create a hardship. Fortunately, this problem too was foreseen and covered by the Closing Agreement of 1947, which provides: "The benefit of deposits of ordinary income shall be allowed in the same year that such income accrued, regardless of the date of actual deposit . . ."

As the 1950 income recovered by litigation in 1956 would be taxable in 1956, the tax benefits due to the deposit thereof are allowable also in 1956.

Application of reserve funds

As already mentioned, the deposits accumulated in the reserve funds may consist of capital items (cost basis and depreciation of ships), capital gains (profits on disposition of ships) and ordinary income (operating earnings, interest on investment of funds, etc.). When a payment or a withdrawal from the reserve funds is made, it is necessary to know whether it consists of capital, capital gains or ordinary income. For this purpose, both reserve funds are treated as a unit, and then the "first-in, first-out" rule is applied. The "ins" and the "outs" are taken as actually made, i.e., on a "cash" basis. Some rather interesting tax results can flow from this rule, depending on the order in which the reserve funds are used. Suppose the company is faced simultaneously with making a payment for a new ship and also with making a "withdrawal" to its general funds. Obviously, the "outs" should be arranged, if possible, so that the taxable "withdrawal" will come, in order of preference, from nontaxable capital or low-taxed capital gain; and the nontaxable investment in ships should be made, if possible, from ordinary income or capital gains.

Depreciation and amortization

There is probably no industry that has a larger proportion of its total capital tied up in fixed assets than does the shipping industry, and therefore has a greater interest in allowances for de-

preciation and amortization.

For many years, the Treasury Department insisted that 3% per year was the reasonable rate of depreciation for a ship. It pointed out that there were many ships operating in good times at the age of thirty-three years or more. The answer was that it was like the schoolboy's knife which has had two new blades and one new handle. If you are willing to stand the repair and reconditioning costs, a ship can be kept operating indefinitely. As a practical matter, after her third survey at age 18, a ship frequently becomes uneconomical to operate, except in times of unusual demand for tonnage. After years of hearings and negotiation, a general depreciation rate of 4% was allowed for ships. After the Merchant Marine Act of 1936 set the limit for subsidized operation at 20 years and required deposits of 5% annual depreciation, the Treasury Department allowed a 20-year useful life for subsidized ships.

We shall not dwell here on the various methods of computing depreciation except to indicate that most shipping companies still use 'straight-line' depreciation, although for new passenger liners which are traditionally in highest demand while they are new, the declining balance or sum-of-the-years-digits method would seem advantageous.

Merchant Ship Sales Act of 1946

The most troublesome aspect of ships' cost basis and depreciation problems arises under the Merchant Ship Sales Act of 1946. That Act authorized sale of Government's war-built surplus ships at a "statutory sales price." At the same time, to be fair to those who purchased Government ships during the War (after 1940), the Act authorized an "adjustment" of the price of such ships, under a formula which attempted to approximate what the situation would have been if the ships had not been purchased until 1946 and then at the statutory sales price. In brief, the shipowner was credited with the excess of his original purchase price over the statutory sales price, and with an interest allowance on such excess, debited with a charter-hire rate on the vessel up to 1946, and then credited with such part of his taxes as applied to the charter-hire. The net of these adjustments was then deducted from the original wartime price, and the balance was the "adjusted purchase price." It is obvious that actual adjusted price under the formula is invariably higher than the "statutory sales price," because all of the net profits (after taxes) of interim ownership were taken away.

What is the depreciable cost basis of such vessel? The Treasury Department, supported by the Maritime Administration, held that the new cost basis is the "statutory sales price" on the theory that the adjustments were income and tax adjustments required as a condition precedent to reducing the capital adjustment of price down to the "statutory sales price." The shipowners claimed that the whole formula was a capital cost adjustment, measured in part by income and tax items, and consequently the adjusted cost basis was considerably higher than the "statutory sales price."

Congress agreed with the shipowners, and passed a bill providing that the adjusted cost basis is the original purchase price reduced by the net of all adjustments provided in Section 9 (b) of the Merchant Ship Sales Act of 1946. The President vetoed the bill. When the issue was recently litigated (*Barber Oil Corp.*, DC N. J., 10/25/55; 135 F. Supp. 451, 457. Case settled and not appealed by the Government.) as a tax case, the court upheld the position taken by Congress and the shipowners.

Emergency amortization

The Internal Revenue Code permits by election a special amortization allowance over a period of 60 months for such "emergency facility," built or acquired after 1949 and before 1957, as is certified by the proper Government agency to be necessary in the interests of national defense. It may seem at first blush that this provision would be particularly beneficial to a shipowner, and that a ship is a prime example of an emergency facility. In practice, however, these special amortization provisions have not been used in respect of ships to the extent that might seem likely. There are several reasons for this, the foremost obstacle being the fact that at outbreak of war or other national emergency, the Government immediately requisitions all shipping facilities, including ships, shipyards and ships under construction. While there have been important instances of the application of emergency amortization to ships, perhaps analogy of the amortization provision has been of greater importance to ship owners generally than the amortization itself.

When the war in Europe broke out in 1939 and demand for ships became great, many shipowners at great expense acquired and reconditioned laid-up ships that were twenty-five years of age or older. What depreciation rate was applicable? The Treasury turned to its ancient rule of thirty-three years, and insisted the write-off be spread over eight years. The shipowner considered that the emergency would be over in anywhere from two to four years. While the emergency-facility amortization provisions were not applicable, they did furnish an analogy so convincing that depreciation and obsolescence were generally allowed on a five-year basis.

Conclusion

The tax problems of the shipping industry are numerous and frequently unique. Their solutions are often found in unusual applications and little-known formulae. Being particularly vulnerable, both to a multiplicity of taxes and to problems that are *sui generis*, the shipping industry and its tax problems present a fascinating field. ☆

New foreign decisions this month

No exemption; taxpayer wasn't actually resident in China for full year. Taxpayer, a citizen of the United States, established a residence in China in 1929. In 1941 taxpayer and his family returned to the United States. As soon as the war was over, in February 1946, the taxpayer returned to China. He left China in November 1947 to engage in another business. The Tax Court held that while taxpayer may have intended at all times to return to China as soon as conditions permitted, the statute exempting income of citizens resident in a foreign country for the full taxable year requires actual residence and not domicile. Since taxpayer was not actually resident in China during the full years 1946 and 1947, his income for those years is not exempt. This court affirms. It also upheld additions to the tax for failure to file. Taxpayer's belief that he was exempt was not reasonable cause; he did not show that he consulted counsel. [Under the 1939 Code, the exemption applied only to a bona fide resi-

dent for a full year; under the 1954 Code, physical presence abroad for 18 months may qualify. *Ed.*] *Hennigsen*, CA-4, 5/27/57.

Taxpayer on indefinite foreign assignments is foreign resident. Taxpayer claimed he was a bona fide resident of foreign countries and exempt on foreign salary for 1947, 1948 and 1949, when he was employed to set up factories in foreign countries. As soon as the new factory functioned smoothly, he moved to another country to set up another factory. He set up a factory for his employer in Australia and lived there from June 1946 to October 1948. His next assignment was in Canada. Between assignments, he returned to the U. S. to marry his Australian fiancee. In July 1949, he was transferred to England. The district court found that taxpayer never intended to become a resident of a foreign country. He had never set up a permanent home. His intention was to be in foreign countries only as long as his employer directed him to stay. This court reverses. This is a mixed question of law and fact and it is not bound by the district court finding. It holds that taxpayer was no mere transient and the court below interpreted "resident" too restrictively. One dissent—taxpayer's tours of duty were only temporary though indefinite. The result is to allow taxpayer to escape Australian tax as a U. S. resident and U. S. tax as an Australian resident. [Under current law, physical presence abroad for 510 days in 18 months qualifies $20,000 of foreign earnings for exclusion. *Ed.*] *Weible*, CA-9, 4/15/57.

Services on high seas subject to U. S. tax. An employer is not required to withhold income tax from U. S. citizens for services within Puerto Rico if they are bona fide residents or if withholding is made under foreign law. The IRS now rules that remuneration paid to U. S. citizens who are residents of Puerto Rico for services performed as crew members of a fishing vessel on the high seas is subject to income tax withholding because the service is not rendered within Puerto Rico. *Rev. Rul.* 57-236.

1929 Patent Transfer by nonresident foreign firm was sale; installment payments after 1935 are nontaxable. In 1929 a nonresident foreign corporation, not engaged in business in, or having an office in, the United States, transferred certain rights under a patent to an American corporation for a total consideration to be paid anually based on production, but not less than an annual minimum. This, the IRS rules, was a transfer of all rights and therefore a sale. The installments for the 1940-1943 could not be paid because of enemy occupation of the foreign country: these installments were paid in 1953 and the question here is the tax treatment of those installments. Prior to 1936 such foreign corporations were taxed on all gross income from the United States but withholding was not required. The 1936 Revenue Act taxed foreign corporations on fixed or determinable income, specifically including royalties, but excluding proceeds of sale. Since these installments were proceeds of sale, they are not taxable for 1936 and subsequent years. *Rev. Rul.* 57-317.

Can deduct bribes to obtain foreign government contracts if the government itself acquiesces. In a letter to Senator forth the policy of the IRS in allowing forth the policy of th eIRS in allowing deduction of bribes paid to foreign government officials to obtain contracts with foreign governments. If the foreign government itself demands or permits the payments, the Commissioner says, the IRS would find it hard to sustain the position that the payments are not ordinary and necessary. In these situations, he says, sharply defined Federal policy is not involved. *Spec. Rul.* 3/11/57.

Computing exempt pay of Canadian transportation workers in the U. S. part-time. The income tax convention between the U. S. and Canada provides for the exemption from U. S. income tax of compensation paid to a Canadian resident for personal services rendered in the U. S. if he is not present more than 183 days in the year. Transportation workers between points in the U. S. and Canada are to compute their days in the U. S. in the following manner: a working period of eight hours or more in the U. S. is one day; a period of less than eight hours is one day, if it is treated as a full work day; if it is not, it is the same fraction of a day as its length in hours is of eight. Whole and fractional days are to be accumulated to determine whether the worker was in the U. S. for 183 days. *Rev. Rul.* 57-330.

Must withhold on wages paid to refugee parolees. An alien resident in the United States is subject to income tax withholding just like a citizen. Hungarian refugees admitted either under a visa or as parolees are alien residents. Withholding must be made on wages paid to them. *Rev. Rul.* 57-331.

Credit allowable for Canadian withholding tax on liquidation. The 15% tax withheld by a Canadian corporation on liquidating distributions to a U. S. resident shareholder is deemed to be an income tax and will be allowed as a foreign tax credit to the extent permitted by Code Section 901. *Rev. Rul.* 57-348.

Withholding on dividends on joint stock; one spouse an alien. Corporations are required to withhold income tax on dividends paid to nonresident aliens. The IRS rules that stock, jointly owned by husband and wife is treated as owned one half by each. Consequently, when one spouse is a nonresident alien the corporation is required to withhold only half the dividend. *Rev. Rul.* 57-299.

Nonresident alien trading through attorneys-in-fact not "engaged" in trade or business. A nonresident alien who is engaged in trade or business within the U. S. is taxable on U. S. income. However, the Code provides that "trade or business" does not include transactions through a resident broker in marketable securities. Taxpayer, a nonresident alien with assets of over $2 million in the U. S., executed a power of attorney to two New York lawyers. During the taxable year they purchased and sold securities and made one sale of commodity futures on behalf of taxpayer. The lawyers also acted as officers and directors of taxpayer's two U. S. corporations which owned citrus groves in Florida. The court concludes taxpayer's activities in connection with the citrus groves did not amount to business here; the securities transactions were specifically exempt. Accordingly, capital gains on his security and commodity transactions were not subject to U. S. tax. *Neuman de Vegvar*, 28 TC No. 120.

Revised withholding rates under foreign tax conventions. The IRS has released a revised schedule of withholding tax rates under current tax treaties with respect to dividends, interest, royalties, and real estate rentals paid to nonresident aliens. *Rev. Rul.* 57-391.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Techniques for insuring deductibility of travel and entertainment expenses

by **JOHN D. MANESS**

Probably most executives with an expense account have learned the hard way that slipshod record keeping for travel and entertainment outlays just won't go with the IRS anymore. Proof that the item is allowable and of the amount spent must be produced. Mr. Maness, in a paper presented recently before the California Society of CPAs reviewed briefly the troublesome distinctions between personal and business expenses and then turned to the most popular methods of paying and recording them, discussing the advantages and disadvantages of each from the viewpoint of convincing the tax agent.

IN 1953, THE COMMISSIONER of Internal Revenue announced a policy on travel and entertainment expenses which some labeled as a "get tough" policy. Apparently the announcement was taken too seriously by many examining agents. In a later release there was an easing of the travel and entertainment expense policy to the extent that agents were requested to use a rule of reason instead of requiring documentary proof of the precise amount of every item. But it became standard operating procedure with the revenue agents to examine the officers' individual tax returns at the same time a corporation's return was examined. During recent months frequent press notices again indicate that the Internal Revenue Service seems to be "cracking down" on taxpayers without adequate records, proof and justification for expenditures. Taxpayers will have to have better records than heretofore to protect themselves.

Three tests have been formulated in determining whether travel expenses are deductible. The first two tests also apply to entertainment expenses.

1. *Is the expense a reasonable, ordinary and necessary expense?*

I believe such a phrase as it is generally understood has the same meaning for tax purposes; that is, what the average prudent businessman would have done in a similar situation.

2. *Was it incurred in pursuit of business and with a business purpose?*

This means that there must be a direct connection between the expenditure and the carrying on of a trade or business and the expenditure must be appropriate to the pursuit or development of the trade or business.

3. *Was the expense incurred "while away from home"? Or rather, while away from your tax home?*

This term has a special meaning for tax purposes. Your tax home isn't necessarily your personal residence. The Internal Revenue Service and the courts generally agree that a taxpayer's tax home is at his principal place of business. If his residence happens to be far away, that is a matter of personal choice and he cannot make tax capital of it. Of course, a temporary assignment out of town does not change his tax home. He is away from home even though he has living quarters at his temporary post. Traveling expenses between his tax home and his temporary post are deductible. However, if this assignment is of long or indefinite duration it may be treated as a shift of tax home.

Commuting expenses are not deductible at all. If you simply travel from your residence to your regular place of business (your tax home) you cannot deduct travel expenses. Sometimes it is a pretty close question whether an item is a nondeductible commuting expense or a deductible travel expense.

A recent Internal Revenue Service publication (IRS Publication No. 300 (1956)) defines home as: "The place of business, employment station, or post of duty, regardless of residence . . . not limited to a particular building or property but including the entire city or general area where business premises are located." The same publication stated that an overnight trip was required to constitute travel, and defined overnight as a period substantially longer than an ordinary day's work and of sufficient length to necessitate relief to obtain sleep— not necessarily 24 hours or from dusk to dawn, but to obtain necessary sleep, not merely to rest or obtain a meal.

In one case a man took a job in a distant city but did not change his residence. Under the terms of his employment, he paid his travel expenses between the two cities and his living expenses in both places. He was not allowed to deduct his travel or his meals and hotel bills in the city where his job was. That was his tax home (*Flowers*, 326 U.S. 465).

In another case, a store manager was allowed a deduction for trips in his own car from and back to his home. The story was that every Sunday he had to confer with the store owners at a point 36 miles away. The court called it deductible "travel while away from home" even though it wasn't overnight (*Waters*, 12 TC 414). But this case is not very good insurance. The Treasury Department still takes the position that the travel must be away from home overnight.

The Commissioner has ruled, in Rev. Rul. 55-109, IRB 1955-9, 14, that an employee who works for two different employers on the same day may deduct the cost of traveling between the two places of employment. A similar deduction is allowed a person who works for one employer in two different locations and who is not reimbursed for traveling between the two points.

Accounting practices

The importance of assembling and recording data which will establish the validity and amount of travel and entertainment expenses cannot be stressed too

greatly. Accounting practices in the field of travel and entertainment expenses vary widely as between different business enterprises. Certain of the problems encountered in obtaining allowance of the expenses can be overcome in a practical manner through selection of the method of reimbursement. Let's review four fundamental ways in which a company can handle business expenses of its employees.

Nonreimbursed expense

Sometimes salaried executives are not reimbursed for entertainment expenses. In other cases, certain expenses are recognized by the company as eligible for reimbursement while others are not so recognized and must be borne by the executive personally.

The question arises as to whether the fact of nonreimbursement in itself would prohibit a deduction in the individual's return. Examining agents are inclined to advance the argument that if the company does not reimburse the executive, the business nature of the expense must be questionable. (A logical deduction—but perhaps I am prejudiced because I once worked as an agent.)

In such a situation the executive must keep records to show the amounts and purposes of such nonreimbursed expenditures; he must establish that they are in fact business expenses and that they are ordinary and necessary. He must show that the expenses were incurred for the corporation's benefit or reasonable expectation of future benefit; that his position required that he incur such expense; and that the reason he was not reimbursed was that the expenses were considered a part of the cost of earning his salary and that the salary level was established to include such expenditures.

Statements contained in the employment contract, corporate minutes, or in a memorandum from the corporation are helpful in satisfying these requirements. The more specific such documents are the more valuable they will become in case of dispute. They should spell out at least major types of expenses which the executive is expected to incur without reimbursement and state specifically that the expenses are to be incurred for the company's benefit.

Extra pay for expenses

The employee's compensation can be set at a figure which includes anticipated business expenses. Under this method the employee must take the deductions on his own income tax return, and it will be his primary burden to prove them; that is, that they were actually incurred or paid, that they were reasonable, and that they were required to be incurred for the employer's benefit.

From the employer's viewpoint, fixing compensation to include anticipated expenses is least costly from an accounting viewpoint and avoids abuse of expense accounts. No particular tax problems are presented if the over-all payments would not exceed reasonable compensation for the services of the employee. (I'll let you define "reasonable.")

There are some pitfalls to be guarded against. The disallowance of travel and entertainment expenses claimed by employees on the ground that it is not part of the employee's duties to incur such expenditures can best be avoided by a written statement from the employer stating that certain out-of-pocket expenses are required to be paid by the employee contract, included in the corporate minutes or can be in the form of a memorandum from the employer.

Also, a stockholder-executive should guard against a pitfall that is best illustrated by an example. A salesman's travel and entertainment expense is connected with his business of earning commissions. But similar expenditures by a stockholder (who doesn't depend on commissions), while they may be recognized as business expenses, may be considered as expenses of the corporation, not deductible by the stockholder (*Kaplan*, 21 TC 134).

Reimbursed expense

You can have the employee submit an itemized expense account and reimburse him for what was expended. The company must take the deductions on its return. The employee includes the reimbursement in income and deducts the outlays on his own income tax return, but he has the detailed expense account, approved by the company, to help him prove them. Remember, whoever claims business expense deductions must prove two things:

1. The expenses were for business purposes, not personal business.
2. The amounts claimed were actually spent.

It is much easier, as a general rule, for the company to prove those things. First, on the question of whether it is a business expense or not, the company has two chances. If such payments to an employee cannot be called reimbursement for his business expenses, then it is additional salary to the employee and can be deducted anyway. Second, the Treasury Department feels that an individual who claims a business expense is by no means a disinterested party. On the other hand, if an expense account has survived the scrutiny of a travel-wise sales manager and a cost-conscious comptroller, Uncle Sam usually assumes that the expense is ordinary and necessary and is primarily for business purposes. The true employer-employee relationship serves as a form of check and balance. Therefore, all other things being equal, a reimbursement policy gives employees more tax protection than a salary-plus or extra-pay policy. Even though the employee may still be called on to prove the deductions on his own return, he has his company-approved expense accounts to help him sustain them. This method will generally produce the better tax results for the employee in cases where his actual deductions (other than Page 2 entertainment, etc.) are less than the standard deductions.

With the possible exception of stockholder-executives of closely held corporations, partners, and sole proprietors, the above practice will generally nullify an attempt by the examining agent to disallow expense deductions on the ground that it is not part of the employee's job to incur the expense. Closely held corporations, partnerships and proprietorships are often required to furnish as much detail in support of expenses as the individual. So many times in the smaller corporations, partnerships and proprietorships, travel and entertainment expenses are paid to the owner by check payable to himself or out of petty cash in round amounts, without

Reimbursed expenses on new 1040

THE NEW 1957 Form 1040 has one significant change from that of 1956: right on page one, after item five, Wages, salaries, etc., comes a new item six, Less (a) "Travel, reimbursed expenses, etc." In prior years taxpayers claiming such items were directed to make the deduction on an attached schedule. The prominent position now given to this expense will make it easier for the IRS to spot large claims and schedule such returns for audit.

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any details or other supporting information. Needless to say, such procedure is not recommended. If it is a closely held corporation and part or all of such deduction is disallowed because it is not substantiated, or is unreasonable or unnecessary, the corporation will be penalized to the extent of the disallowance. Also, the amount disallowed will probably be treated as additional income to the officer-stockholder.

Under the reimbursement method, the employer does not have to withhold tax on such payments, if they are separately stated. Also, such payments need not be reported on information return, Form 1099, if the employee periodically accounts to the employer for such expense (Mim. 5947; 1945 C.B. 235).

This is an even more desirable method from the employee's point of view. Have the company pay the bill directly, without the money ever passing through the employee's hands. The employee never takes the amount into gross income and doesn't have to worry about defending the deductions. Obviously, this technique is not suitable or possible in all situations, but certain kinds of expenses are adaptable:

1. Charge accounts can be established at hotels where employees who travel usually stay.

2. Permanent living accommodations in places where executives frequently spend time. The lease to rented quarters can be taken in the company's name.

3. Vehicles used for business can be bought by the company, and the related repair, gas, oil and maintenance bills paid directly by the company.

4. Transportation tickets can be purchased on company credit.

5. Entertainment bills from clubs, hotels, restaurants through established credit or through one of the national credit agencies.

Direct payment by the company or provision for reimbursement of actual expenses will generally be more advantageous from the standpoint of substantiation and of establishing that incurring the expense was a requisite part of the employee's occupation.

There are, of course, many variations of these four methods of handling business expenses.

Certain basic requirements and the degree of latitude can be ascertained from recent Revenue Rulings. The Commissioner recognizes that it is impossible to substantiate each and every expenditure. Where an individual has evidently incurred some deductible expenses but does not possess documentary proof thereof, he should be allowed a reasonable approximation of such items by resorting to reliable secondary sources of information and collateral evidence (Rev. Rul. 54-195, IRB 1954-1 CB47). The burden of proof in such cases falls upon the taxpayer, and doubts resulting from vague and unsatisfactory evidence may properly be resolved against him whose inexactitude is of his own making.

Rev. Rul. 54-497 states: "To substantiate his expenses, a taxpayer is not required to secure, retain, and produce receipts for each meal and for each night's lodging. . . . As stated in the *Cohan* case, absolute certainty in such matters is usually impossible and is not necessary."

The ruling goes on to suggest that a day-by-day record should be kept which would at least indicate:

1. The dates, duration and destination of each trip.

2. The amounts paid for lodging or quarters.

3. The actual cost of each meal consumed on trips.

However, recognition is accorded to the fact that not all employees keep such detail records, and although there must be something more than a bare lump sum estimate, many employees can still substantiate most of the deductible expenses with some degree of accuracy. The ruling continues: "Presumably they should be able to compute such expenses, with reasonable precision, by estimating conservatively the amounts paid for lodging and the average cost of the various meals, provided they can ascertain from time sheets, assignment lists or other available data, or if they can fairly reconstruct, the number and duration of those trips during which they were required to obtain lodging as necessary rest while "away from home"; and the various meals which they had to purchase on such trips."

A minimum record in the form of a day-by-day log covering the following items should be kept.

1. Dates.
2. Persons and places visited and why.
3. Duration and destination of trips.
4. Lodging particulars.
5. Methods of transportation.
6. If entertainment is involved, names, places, business connection and exact or approximate amounts.

Some individuals merely accumulate receipts, stubs, memos and other data relating to expenses in a folder throughout the year. The resulting record is not necessarily neat, but the support for expenditure is there.

Adequate and accurate records are still the best bet when it comes to backing up claimed deductions for travel and entertainment expenses. The secret of successful expense records for tax purposes is to keep them as you go along, not reconstruct them at the year-end.

The Sutter principle

A recent court decision has injected a new principle in the field of travel and entertainment expenses. In the *Sutter* case (*R. A. Sutter*, 21 TC 170) the amount spent by an individual in entertaining customers or clients was not deductible to the extent attributable to the taxpayer and his family. The Tax Court held that the deduction would be allowed only for those expenditures which were different from or in excess of those which would have been made for the taxpayer's personal purposes. The implication of this case is illustrated in the example of a salaried executive taking a customer to lunch at a restaurant where lunches cost $2.50 or a total of $5 for the two of them. The executive can deduct only $4 if he normally spends $1 for his own lunch.

This principle should not apply to expenses incurred on out of town trips since the Code permits a deduction for "traveling expenses (including the entire amount expended for meals and lodgings) while away from home" on business (I.R.C. Sec. 162 (a)(2)).

A question arises as to whether this principle will affect the deductions by corporations which reimburse officers or employees for such expenses. In the past, corporations have deducted the reimbursed amount as an ordinary and necessary business expense where the expenditures were incurred in the conduct of the corporation's business.

If the *Sutter* decision is correct, the corporation would in fact be paying a personal expense of the employee to the extent of the amount he otherwise would have paid for his own meal or entertainment. This could constitute additional compensation subject to withholding.

As a practical matter, if the employee is expected to do the entertaining, and if the procedure is unquestionably not for

the purpose of tax avoidance on the part of the employee, the amounts should be considered as primarily for the convenience of the employer and therefore should not be treated as additional compensation like supper money payments.

Apparently, if the *Sutter* principle stands the taxpayer will have to establish that the expense portion, which is attributable to the cost of his own meals or entertainment, would not have been incurred except for business reasons.

Proposed regulations (Sec. 1.162-2) on traveling expenses were issued on July 10, 1956 but the final regulations have not yet been adopted. The proposed regulations do not suggest any startling changes that have not already been common practice. Paragraph (g) of Sec. 1.162-2 states that a "taxpayer claiming the deductions for traveling expenses . . ." must attach to his income tax return, a statement showing (1) the nature of the business in which engaged; (2) the number of days away from home during the taxable year on account of business; (3) the total amount of other expenses incident to travel and claimed as a deduction.

Conclusion

The settlement of disputes involving travel and entertainment expenses, where there is a lack of substantiating data or a problem as to whether they are business or personal, can be further complicated where similar items have been claimed in subsequent years' returns. If either of the above two problems exists in the returns in later years, it is difficult to settle on a more favorable basis than that of the earlier or first settlement. When a taxpayer is confronted with this type of problem, he realizes too late how much better off he would have been had he practiced a reasonable and consistent program of accounting for his travel and entertainment expenses. Adequate and accurate records are still the best bet when it comes to backing up claimed deductions for travel and entertainment expenses. ☆

New decisions affecting individuals

State hospital employees not taxable on meals and lodging (Old Law). The 1954 Code specifically provides that meals and lodging furnished to an employee by his employer are not income of the employee if furnished for the convenience of the employer, if the lodging must be accepted and if the meals are consumed on the employer's premises. Prior thereto the matter was covered by Regulation. For many years convenience of the employer had been the sole test and taxpayers here, employees of a state hospital, had never been taxed on the facilities furnished them. However, the Commissioner changed the Regulation to say that convenience of the employer was a test to be employed only if there was no other evidence whether the facilities were in fact compensation. In many cases involving Government employees the Commissioner had pointed to the valuation of the meals and lodging by the Civil Service Commission as showing that they were in fact compensation. However, the report here makes no mention of any such valuation. The Court notes that the Second Circuit held (*Diamond v. Sturr*, 221 F.2d 264) that the old Regulation had been so long used it could not be upset merely by Regulation. It follows the rule in its own Third Circuit (*Saunders*, 215 F.2d 768) and finding the convenience to the state was the most important factor, despite the economic advantage to the employees, finds them not taxable on the meals and lodging. *Gordon*, DC N. J., 6/28/57.

Subsistence allowances of state-highway patrolmen are additional compensation Old Law). Taxpayer, a member of the Georgia State Patrol, was required to live in a barracks and was on call 24 hours a day. He received a subsistence allowance of $4.50 a day to defray the costs of his meals, which he ate at restaurants on his route. The Tax Court held this taxable as additional compensation. This court affirms. The "convenience of employer" rule is inapplicable; it was argued that if the state supplied meals, the patrolmen would all be off-duty at the same time. The court cannot find that taxpayer"s eating of meals in a restaurant of his choice, paid for from the subsistence allowance, should result in favored tax treatment denied all other employee-taxpayers who eat one or more meals away from home. [Under the 1945 Code, meals and lodging for the convenience of the employer are excluded, whether or not they are compensation. But this applies only to meals eaten on the business premises. *Ed.*] *Magness*, CA-5, 7/13/57.

Payments on mortgage pursuant to divorce decree not alimony. Pursuant to a divorce decree taxpayer was required to make monthly payments to discharge a mortgage on the house which was to remain the property of his ex-wife. The court holds these payments were not intended as alimony. Further, the payments are of a fixed sum and will be completed in less than ten years, so the deduction is specifically forbidden by the Code. *Klemm*, DC Wis., 8/20/57.

No exemption on medical expenses for wife separated by Louisiana decree. The 1939 Code provided that an individual legally separated under a decree of divorce or separate maintenance shall not be considered as married. Taxpayer-husband had received a Louisiana decree of separation from bed and board. He claimed an exemption for his wife and also deducted for medical expenses which he paid on her behalf. Under Louisiana law, absent any provisions in such a decree, the husband is not liable for medical expenses of his wife and she cannot contract for the community. The court holds the decree constituted a "limited divorce decree" which suffices to render the parties unmarried for purposes of the exemption and medical deduction. The items were therefore disallowed. *Garsaud*, 28 TC No. 125.

Court finds wife intended to sign only as preparer. The trial court had entered judgement against taxpayer-wife for a relatively small amount of interest. Actually, the court finds, the wife intended to sign only as a person assisting in the preparation of the return. It follows that the return was not joint and that she is not liable for interest. *Payne*, CA-8, 8/8/57.

Lump sum receipt for "alimony and maintenance of child" taxable in full. Taxpayer was divorced from her husband in 1947 and was awarded custody of their minor child. The decree awarded her $27.50 per week as lump sum "alimony and maintenance of child." In spite of a later award in 1953 of a lesser amount for the exclusive support of the child, the court holds the entire payment for each of the years prior to 1953 constituted taxable ali-

mony to the wife, since the decree did not designate any part of the payment as payable for the child's support. *Hummel*, 28 TC No. 131.

IRS rules joint returns allowed despite interlocutory decree. Despite court decisions to the contrary, the Commissioner had insisted that persons who had received an interlocutory decree of divorce which was not yet final were "separated under a decree of divorce" and not entitled to file joint returns. It is now held that they may file joint returns under both the 1939 and 1954 Codes. Nonacquiescences in decisions to the contrary are withdrawn. [See *Eccles* and *Lane* below.—*Ed.*] *Rev. Rul.* 57-368.

Joint return permitted despite interlocutory divorce [*Acquiescence*]. The Tax Court held that taxpayer and his wife, who had received a California interlocutory decree of divorce which, at December 31, was not yet final, were still husband and wife entitled to file a joint return. This case was affirmed, 208 F.2d 796, (4th Cir. 1953). *Eccles*, 19 TC 1049, *acq.* IRB 1957-32; similarly *Lane*, 26 TC 405, *acq.* IRB 1957-32.

Support payments while decree interlocutory not alimony (Old Law) [*Acquiescence*]. Taxpayer received alimony pendente lite while her Colorado interlocutory divorce decree was not yet final. The Tax Court held that under Colorado law the marriage was not dissolved until the decree became final and therefore the support payments prior thereto were not taxable alimony. This case was affirmed, 211 F.2d 378. [The 1954 Code gave alimony treatment to payments under a "decree for support" and the proposed Regulations on this point include as alimony payments under interlocutory decrees if the parties are living apart and file separate returns. —*Ed.*] *Evans*, 19 TC 1102, *acq.* IRB 1957-32.

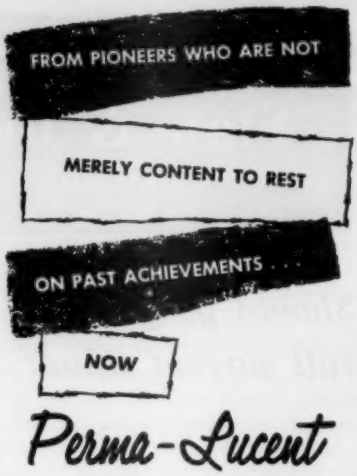
Filing final return by January 15 does not excuse failure to file timely estimate. Taxpayers filed no declarations of estimated tax for 1952 and 1953 but did file their returns by January 15. They argue that no penalty should be imposed because it was widely believed that their procedure was correct and even revenue agents were saying it was satisfactory. Further, they relied on their corporation's accountant who read the Code and Regulations and discussed the matter with a deputy collector. The court holds that the failure arose from the accountant's error or ignorance and that it is not a reasonable cause for failure to file a timely estimate (Old Law). [Under the 1954 Code there is no separate penalty for failure to file an estimate.—*Ed.*] *Solomon*, TCM 1957-167.

Character of partnership and trust income unchanged for determining retirement income. Partnership income, or trust or estate income, reported by a partner or beneficiary, which represents the distribution of rental income, is retirement income for an individual who has attained the age of 65. If personal services are a material factor in the production of rental income, the earned income element must be eliminated when taxpayer is reporting rental income received individually or through a partnership. *Rev. Rul.* 57-351.

Tenant could deduct storm damage if he proved his loss. Taxpayer spent some $700 repairing storm damage to a house he occupied as tenant. The Tax Court denied the deduction because he did not show his basis, saying that the Code denied deduction of a loss in excess of basis. While this court affirms, it notes that the Code is silent on treatment of damage to rented property. It says that the casualty loss affected both the landlord's reversion and the lessee's interest. However, the repair bill does not measure the tenant's loss and the Tax Court properly denied the deduction. *Bonney*, CA-2, 8/2/57.

"Right to exercise family control" test not applicable for head of household. Thus where an individual contributed more than half the cost of maintaining the household where he and his father, stepmother, half-brother and half-sister reside, and the half-brother and half-sister qualify as dependents, he is entitled on proof of these facts only to compute his tax as head of household. *Rev. Rul.* 57-415.

Payment of son's tuition not evidence of support. The Commissioner disallowed as a deduction $570 expended by taxpayer on his son's college tuition and books. Taxpayer then claimed he was entitled to a dependency credit in lieu of the deduction. The court denies the credit in the absence of proof that taxpayer furnished over half of his son's support. *Croff*, TCM 1957-163.



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NEW DEVELOPMENTS IN

State & local taxation

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Should property be assessed at full current value?

by **ERNEST H. JOHNSON**

Few taxing jurisdictions use full value assessments. Values are frequently determined for hypothetical "normal times"; arbitrary percentage valuations are common. Mr. Johnson, in a speech at the recent NAAO Northeastern Regional Conference, reported in the Assessors' News Letter, June, 1957, said forthrightly that current full value assessments are the fairest and should be standard.

I HOPE we may agree that the purpose of assessing property under the general property tax is to assure that the overall tax is fairly distributed according to the worth of taxable property owned. This being so, I suppose the reaction of anyone other than assessors would be: why this fuss over this subject? How can you distribute such taxes fairly except by assessing at current values? Those are good questions.

Of course, many laymen have not heard of the business of "trending back," or of "tying to a stable base period," or whatever other terms assessors use to explain the variance between appraisals for tax purposes and a determination of current worth. So, let us first examine why it is that assessors have not been in the habit of assessing in accordance with current values.

Generally speaking there are two reasons why property changes in value. The first has to do with factors which affect specific properties, or a relatively small group of properties. Under this heading would fall such circumstances as the construction of a new highway or an industrial plant, which have immediate and often radical effects on all surrounding properties. These changes are immediate and readily apparent, and can and should be recognized by assessors as soon as they occur.

But the second reason why property changes in value has to do with a general, and more subtle, change in price levels over a period of time. This increase or decrease in price levels over a period of years is much like the growth of a living thing; such growth is ordinarily imperceptible at close periods, and thus is measured generally only at longer periods when an appreciable change has occurred.

Use of current values

Thus, one familiar with the problem appreciates that assessments cannot always be made in accordance with current values because, the assessment process being as complex as it is, the subtle changes that occur, year by year, in the general price level cannot readily be picked up as they occur, but must be summarized at certain intervals. That is why one finds in certain taxing jurisdictions a provision for reassessments at three-, four- or five-year intervals, the obvious changes due to construction or destruction being recognized year by year, but the less obvious changes being recognized at less frequent intervals.

There is another factor influencing assessments so that they cannot always be made in accordance with current values. It is that, at least so far as real estate is concerned, the courts have tended to hold that the value to be looked for by an assessor is not a fleeting value but a sound long-term, or normal, value. As Professor Buehler has put it, "The Courts have interpreted the fair market value concept to look to a normal or typical value, which may or may not coincide with the current selling prices of property."

The result of these factors influencing tax appraisals has been that one sometimes seems to be dealing with values that are quite removed from reality.

In view of all this, why should assessing at current values be such a burning question with assessors today? In short, why are so many, even now, trying to follow an outmoded price base or using a fraction of full value?

For a period of years, many taxing jurisdictions, if they attempted to make a periodic review of assessments at all, tied such review to 1938-40 price levels. Some years ago this was perhaps natural, since on the one hand were the depression years of 1932-38, and on the other hand the war years of 1940-45. If you were to take any period within reasonably recent years as representing a stable economy, 1938-40 seemed to be the logical period. But this is rationalization rather than reason. The question can be answered less charitably but more succinctly in two words: lethargy and indecision. Lethargy because it takes real effort to make a comprehensive review of the tax roll, and indecision because it is difficult to make up our minds as to what constitutes a stable base period.

Subsequent to 1945 there was for some time a belief that current values were inflationary. As time passed and price levels remained constant or increased rather than dropped, it became clear that 1938-40 was no longer a tenable base price period. Now, nearly 20 years after the base period heretofore generally considered representative of sound value for tax purposes, it would appear that 1955 is a reasonably sound base from which to make a new departure. This base is, in view of present day developments, seemingly stable.

Objections to trending back

Now, what are the objections to this business of "trending back" today?

The most important objection is that it cannot be done successfully. True, so far as buildings are concerned, reasonably reliable factors can be used to determine the reproduction cost in any given period. Possibly, if buildings alone were to be considered, not too much objection could be raised, though even in the case of buildings there are other factors to be considered—factors which we take into account somewhat arbitrarily under the heading of depreciation a

tion and obsolescence—but so far as land is concerned, there is no reliable factor which can be used. We have areas today where land values are in excess of 1940 levels, others where land values are less than 1940 levels. How do you factor that? And so far as personal property is concerned, if you have to worry about that, the situation is quite impossible. How do lumber and gasoline, for example, compare in value today against fifteen or twenty years ago? Or how about television sets and other items of personal property which were unthought of twenty years ago?

Furthermore, trending back creates confusion—and not always in the minds of the taxpayers alone. It is a fine distinction, this difference between what a given property was worth itself in 1940 and what we consider its appraisal today on the basis of 1940 prices. Small wonder that a convincing explanation of the process is difficult to make.

Assessing at current values

At this point it might be well to define exactly what I am talking about when I speak of assessing *at* current values. This can mean what it says, or it can mean assessing "in accordance with" current values. In the former case, if a property is considered to be worth $10,000, it will be valued for tax purposes at $10,000. In the latter case, it may be assessed at $1,000 and no inequity will result so long as all other property is assessed at one-tenth of actual value. I would say that the current value to be used by assessors should be on the conservative side, more in accordance with the "bid" than the "asked" price.

If realistic present day values are used, and realistic valuations are used—by this I mean full appraised value, rather than 20% to 50% of worth—there are some very important benefits to be obtained. Realistic valuations protect the taxpayer. This is a point which taxpayers have long been blissfully ignoring. So far as review of assessments, or appeal, is concerned, the taxpayer whose property is valued at 20% of what it is worth has a very poor chance of showing that he is being unjustly treated, even though it may be that some other taxpayer is being assessed at but 10% of what his property is worth. On the other hand, if full value on a current basis were the practice such a taxpayer would enjoy a far better opportunity of protecting himself. First, a difference of $1,000 in valuation would mean $1,000 in value, not $5,000 in value. Second, if property is worth $5,000 and is valued for tax purposes at $6,000, the taxpayer presumably would be able to show over-valuation. Certainly when his property is valued at $1,000 and is worth $5,000 he is engaged on a difficult task if he seeks to prove over-valuation.

Furthermore,, a combination of realistic price base and realistic valuation will result in a realistic tax rate. Too many people look at only one item in the tax picture of a community, and that item is tax rate. You and I know that tax rate means nothing unless the valuation practice is also considered. Unfortunately, taxpayers, and particularly strangers to the area, do not know this. Depressed valuations and the resulting astronomical tax rates are very poor advertising.

The incidental effects of depressed, outmoded valuations can be serious. When an exemption is limited in dollar value by law, a depressed valuation results in an inflated exemption. We in Maine have an exemption up to $3,500 in valuation for the property of certain veterans. We have had some complaints from town officials with respect to the loss of valuation because of such exemptions. It is difficult to sympathize wholeheartedly with an official complaining in this respect when it is found that his town is valuing property for tax purposes at 20% of its present-day worth. In such a case the assessors actually commit the town to an increase in the exemptions, from a maximum valuation per veteran of $3,500 to a maximum valuation of $17,500. I don't know what other incidental effects there may be in other states, but you might be interested in just one in Maine—namely, local debt limitation. The power of a municipality to incur indebtedness is limited by the Maine Constitution to 7½% of the local valuation. Where local valuations are depressed by the use of outdated figures, the result has been to inhibit borrowing capacity. Rather than attack the problem at its base by revising the valuation procedures, the easy way out has been to overcome this debt limitation by creating so-called districts which have borrowing capacities of their own. This is a subterfuge which would be quite unnecessary were more realistic local valuations used.

Of course the major pitfall has probably already occurred to you—there is the possibility of an abrupt drop in price levels. No one wants to find himself in the position of having ventured too far out on a limb. In reality, this hazard is not so serious as it might at first appear. The changes that throw assessments out of proportion are not those abrupt drops, which are quite likely to affect all types of property in more or less the same fashion, but those long-term and less perceptible changes I have spoken of which affect different types of property differently. If we assess this year in accordance with current values and the bottom should drop out of prices within the next 12 months it is quite possible that a percentage adjustment across the board would result in a valuation for next year better than many of us can now hope for on the basis of outmoded figures.

The second pitfall is the fact that when they assess at current values assessors must know what they are doing and they must base their assessments on facts. Furthermore, it is probable, in view of the present sad state of property tax assessments in many jurisdictions, that assessors may first have to plan a comprehensive program of educating the public as to what they propose to do and why.

If assessors propose to use current value for assessments they are going to have to know what they are talking about, and they are going to have to take the taxpayers into their confidence. It may be much easier to defend the figures now on many assessment books simply because they have no relation to anything that exists today, and consequently the assessor cannot readily be pinned down. The figures are such a complete mystery to everyone concerned that there is no basis for argument. But that is hardly a merit.

When I was discussing merits, I mentioned realistic tax rates. If a realistic tax rate is a merit from the point of view of public relations, some people feel it is a pitfall in that a lower tax rate encourages more expenditures, and it must be considered because it has obtained a certain degree of public acceptance. We in Maine simply do not find this to be true. A review of expenditures in towns with low rates and those with high rates shows absolutely no connection between the level of the tax rate and the degree of increase in expenditures. ☆

[*Ernest H. Johnson is State Tax Assessor of the state of Maine.*]

New state & local decisions

Property rented to AF base not freed of state ad valorem taxes. IBM equipment was rented to and located on an air force base. IBM claimed that since the Federal Government had accepted exclusive jurisdiction over the area as granted by the Georgia legislature, private property located there was no longer subject to local taxation. The court, however, holds that the legislature could not surrender the state's sovereignty without express constitutional power. The attempt of the legislature to cede jurisdiction, the court says, was effective only to the extent of allowing the United States to own and use the land free from state interference by taxes or otherwise. The state constitution, it rules, prohibited the legislature from giving such tax exemption privileges to individuals. *International Business Machine Corp.*, Sp. Ct., Ga., 5/13/57.

Ruling on "oil depot" tax. Tennessee imposes a privilege tax on operators of oil depots. The tax consists of a set of fees graduated according to gallonage received and distributed. Certain amounts of the taxpayer's products were delivered to customers by automotive transports from other oil depots located elsewhere in the county without ever coming into its own oil depot. The state contended that this gallonage should be attributed to the taxpayer's depot in determining its privilege tax liability. The court rules that since taxes presumably must have been paid on the gallonage in question by the oil depots from which the shipments originated, it could not be made the basis for computing taxes owed by the taxpayer. It finds the statutory provision defining an "oil depot" ambiguous but held it the duty of the court to construe it so as to avoid double taxation. *Moto-Pep, Inc.*, Sp. Ct. Tenn., 5/3/57.

Georgia ruling on statute of limitations. A Georgia firm purchased machinery from a Florida company in 1951, neglected to pay use taxes on the purchase, and filed no return for the month of purchase. In 1954, after more than three years had elapsed, Georgia assessed the firm for taxes, penalties, and interest on the purchase. In 1951, Georgia's statute of limitations provided that sales and use taxes had to be assessed within three years after they became due, but in 1953, the law was amended so that in the case of a fraudulent return or a failure to file a return, a tax could be assessed at any time. The state argued that the 1953 amendment applied to a sale which had taken place less than three years prior to its passage. The court holds that the amendment had the effect of extending the statute of limitations as to the collection of the use tax and the assessment thus was valid. *Dixie Construction Co. of Georgia*, Ga. Ct. App., 5/15/57.

Base Louisiana use tax on depreciated value. A drilling rig had been used by taxpayer for some time in Texas before being moved into Louisiana in May, 1953. In June of the next year, the state assessed the company for use tax based on the original cost of the rig plus penalties and interest. The company conceded its liability for the use tax, but contended that the tax should be computed on the basis of the original cost less depreciation. The assessment was based on provisions in the use tax law which imposed the tax on the cost price of the item and defined "cost price" as the actual cost without deduction for any related expenses which it might include. The court holds that the words "cost price" as used in the statute are of doubtful or obscure meaning, the literal application of which would produce an unreasonable result. It points out that a rig purchased in used condition outside the state would be subject to a much smaller tax than a like used rig imported by the original owner. Also, imposing the tax without regard for depreciation could result in a tax which exceeded the actual value of the article. In support of its ruling, the court construes the use tax as designed primarily to affect items purchased outside the state for immediate importation. *S.E.W. Oil Corp.*, Sp. Ct. La., 5/6/57.

Alabama may not tax sales to U. S. Taxpayer had purchased air conditioning equipment from manufacturers, had sold it to Federal and state instrumentalities, and had installed it in buildings they owned. Recognizing the exempt status of proceeds from sales to the Federal Government and the state, the assessment on this sale was based on the definition of a "sale at retail" which includes the sale of building materials to contractors and the use of any tangible personal property by persons purchasing at wholesale. In denying the state's contentions, the court holds that the items could not be construed as building materials and that the company could not be taxed on a use basis since, by Alabama judicial ruling, the consumer was defined as the last person to whom property passes in the course of ownership, who in this case, it holds, was the government agency. The transactions involved, the court says, were ordinary sales in which the company was the seller and the government agencies were tax-exempt buyers. *The Helburn Co., Inc.*, Cir. Ct. Ala., 4/14/57.

Alabama court rules on trading stamps. The validity of state taxation and local taxation and regulation of trading stamps was reviewed in two cases. The question before the court in the first case involved the validity of a 1956 Alabama statute which imposed license taxes on the privilege of issuing and using trading stamps in counties with a population of 400,000 or more. The tax, as imposed on merchants using the stamps, was graduated on the basis of the annual gross volume of business in each separate establishment ranging from $250 when the volume was less than $125,000 up to $3,500 when the volume reached $1.5 million. On firms isuing and redeeming stamps to merchants, the tax was 3% of their gross receipts, with a minimum tax of $2,500. The court holds that the law was unconstitutional as it applied to merchants but valid as it related to trading stamp companies. It construes the former provision to constitute a penalty on the merchant for conducting his business in a certain way and questioned the validity of an exemption in the law for stamps issued for one private brand product only. With respect to the 3% tax imposed on the company issuing the stamps, the court holds this to be a reasonably imposed revenue measure. In the second case, the court holds invalid a local ordinance which provided for license taxes of $10,000 on businesses issuing trading stamps and of $2,500 on retail outlets distributing them. In this case, the court holds that the amount of the tax was so unusual and extraordinary as to be prohibitory, unreasonable and oppressive when ap-

plied to a competitive lawful business. *Sperry & Hutchinson Co. v. Brown*, CA-10, Ala., 5/14/57, and *Sperry & Hutchinson Co. v. City of Birmingham*, CA-10 Ala., 5/14/57.

Tennessee sales tax on labor cost (old law). An amendment to the Tennessee sales tax law adopted in 1949 provided that when a manufacturer, producer, or contractor installs tangible personal property wihch he has manufactured, he shall be liable for taxes on the fair market value of such property without any deductions whatsoever. The court held that a contractor who made ducts and installed them in buildings qualified as a manufacturer. It construed the term "fair market value" in the 1949 amendment to include labor costs involved in producing the finished product. The inclusion of labor costs, it said, would result in the contractor paying the same tax as if the duct had been purchased as a finished product. The future effect of this ruling has been nullified by action taken by the 1957 session of the Tennessee legislature. Effective March 8, the 1957 amendment specifically excludes from the provisions of the 1949 amendment contractors who fabricate tangible personal property which becomes a component part of a building and is not sold by them as a manufactured item. *John McDougall Co.*, Sp. Ct. Tenn., 3/8/57.

Ruling on freezing foodstuffs. Iowa's sales tax law provides an exemption for purchases used in the processing of tangible personal property intended to be sold ultimately at retail. The Iowa Supreme Court holds that electricity employed in the sharp freezing of various foodstuffs was used in processing and was therefore exempt from sales taxation. When used in storing the foodstuffs after the freezing process, it was not exempt. The court holds that processing was involved in the former instance since the products were subjected to special treatment which changed their condition in preparation for the market. With respect to refrigeration, however, the court states the use of electricity in keeping perishable foods did not constitute processing since what was done was merely to preserve them in substantially the same condition. *Fischer Artificial Ice & Cold Storage Co.*, Sp. Ct., Iowa, 3/5/57.

RR's coal mining subsidiary not retailer. In Illinois, a subsidiary coal company sold coal on a nonprofit basis. The character of these sales had been determined in 1917, when the Illinois Public Utilities Commission (now the Illinois Commerce Commission) approved the transfer of the coal company's properties to the railroad company under certain conditions. These were that the price of coal purchased by the parent company from the subsidiary could not exceed the actual cost of production and that the subsidiary company could not sell or supply coal to the general commercial trade. The court holds that the state retailers' occupation (sales) tax could not be imposed on the sale of coal from the subsidiary to the parent company. It rules that the state public utilities commission had in effect forbidden the coal company to engage in business. On the basis on which it had to operate, the court says, the coal company could not be construed as a retailer subject to the state tax. *Valier Coal Co.*, Sp. Ct. Ill., 5/23/57.

Creditor in possession not liable for prior sales taxes. A deficiency sales tax assessment was made after the firm had ceased its operations and had turned over its assets to a creditor company to cover part of its indebtedness. The deficiency assessment was made against the creditor on the basis that the transfer was not a voluntary surrender, but was actually a purchase so that the creditor had succeeded to the business.

The creditor contested the assessment saying that it had made no attempt to operate the business and that, in fact, there had been no business to operate. In setting the assessment aside, the board held that only an ordinary debtor-creditor relationship had existed and that no succession to the business was involved. *L. B. Rose Realty Co.*, Mich. BTA, 5/16/57.

No sales tax exemption for interstate airplanes transporting employees. The Florida sales tax statute exempts the sale of vehicle (the term "vehicle" embracing aircraft) parts used to transport passengers in interstate commerce. However, the sale of aircraft parts to a firm engaged in interstate commerce for installation not in common carriers but in aircraft used to transport employees across state lines was subject to Florida's sales tax. In upholding the tax, the court construed the clause "to transport passengers in interstate commerce" to refer to a public business of transport for value, i.e., a common carrier, and not for the purpose for which the airplanes were used here. In the same case, the court held taxable the use by the taxpayer of parts in changing cargo-type aircraft into executive type passenger airplanes for resale. In doing so, the court upheld a sales tax regulation which provided that since the Florida law exempts new and used vehicles and aircraft from the tax, materials used in rebuilding such property were properly taxable. *Smith Aircraft Corp.*, Sp. Ct. Fla., 4/24/57.

Oklahoma court rules on depletion deduction. Oklahoma's income tax law permits a depletion allowance for oil and gas wells of 20% of gross income with a provision that such allowance shall not exceed 50% of the taxpayer's net income from the property computed without the allowance for depletion. In determining the taxpayer's allowance the tax commission reduced his net income by Federal and state net income taxes. In protesting this procedure, the taxpayer cited a statutory provision defining "adjusted gross income" as gross income minus trade and business deductions from which were specifically excluded Federal and state income taxes. The court held that the provision relating to adjusted gross income had no bearing on the problem in the case. It construed the statutory definition of net income to exclude income tax payments and held that in the absence of unreasonable administration, a taxpayer who desires to take advantage of the depletion deduction must accept burdens as well as benefits of this legislative act of grace. *Daube*, Sp. Ct. Okla., 3/12/57.

No use tax on government contractor. According to the findings, the contractor, Boeing, bought property but was reimbursed for the full purchase price and transportation costs under a contract providing that title should pass direct to the United States. The court said that under the circumstances the United States and not Boeing was the "purchaser" within the meaning of the Kansas compensating use tax act and that the tax could not validly be imposed on the United States. The amount in controversy was in excess of $160,000 covering a period of almost four years. *Boeing Airplane Co.*, DC Sedgwick Cty, Kan., 5/8/57.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

N.Y. package bill vetoed; no increase in UI tax on seasonal industries

NEW YORK STATE has had the unique distinction of having the same unemployment insurance legislation vetoed twice within the space of two months. A "package bill" was passed during the closing days of the regular session and was vetoed by Governor Harriman on April 28. A special session was called, at which time the same legislation was passed and this was again vetoed on June 26.

Probably no proposed legislation in recent years has created the editorial comment and aroused the controversy that this package bill engendered. We found labor and management in seasonal industries opposing the legislation. Substantial numbers of employers outside of seasonal industries did not like it. Others felt that it deserved support. This bill, aside from the technical changes, would have done the following:

1. Increased unemployment benefits from $36 to $45 a week. This would have given New York State the highest straight benefit rate in the country.

2. Provided that a claimant who has worked 15 weeks in the most recent 52-week period prior to filing his claim will be eligible for benefits if he has worked 40 weeks in the 104-week period prior to filing his claim. This would have enabled the claimant to draw his full 26 weeks of benefits. At the present time, no one with less than 20 weeks of employment in the 52-week period prior to filing a claim may receive benefits. This legislation would have, in effect, placed the entitlement test on a 20-week average basis over a two-year period.

3. Provided that employers could combine appeals before the Referee or Appeals Board upon the payment of a single appeal fee if there were a common issue involved. At the present time, each single appeal requires the posting by the employer of a $10 fee for a Referee's hearing and a $25 fee for a hearing before the Appeals Board. The fee is returnable if the decision of the lower body is reversed or modified in the employer's favor. New York State is the only state having such a requirement.

4. Provided that benefits would be denied during a vacation period where the claimant is substantially fully employed both prior to and immediately after the vacation period, even though the vacation payment is considered remuneration for past services as an agreed contractual right.

5. Provided for tax rates above 2.7% for those employers whose contributions to the fund are less than the benefits paid to their terminated employees. The maximum rate would be 3.2% in 1958 and 3.5% thereafter.

6. Provided that all other employers with contribution rates of less than 2.7% would have their rates increased by 0.2%.

7. Eliminated, in effect, the subsidiary contribution to which all, except newly covered employers, are subject, which this year is 0.3% and which is expected to be higher in 1958.

8. Provided for a uniform disqualification period of six weeks for voluntary quits, misconduct and refusal of suitable work. Such disqualification period would begin from the date of separation of employment or refusal of suitable work. At the present time, in the case of voluntary quits, disqualification does not begin until the date the claim is filed. Presently misconduct disqualifications run for seven weeks and refusal of suitable work disqualifications last for the entire period of unemployment.

The seasonal industries, of course, objected to the higher tax rates and were able to convince the labor group that their position should be supported. Other employers felt that the disqualification provisions should be tightened rather than weakened as this bill did. Furthermore, others felt that, with the higher tax rates, it became absolutely necessary that any proposed legislation should include a provision for voluntary contributions. Also, many employers felt that the vacation pay issue should not be a part of this package bill since the proposed legislation in this area represented a compromise solution which was arrived at through conferences of labor and management. It was foreseen that in some quarters, should the bill be vetoed, there would be no remedial legislation in the vacation pay area. This is actually what happened, and during the summer months we saw many stories and read many editorials about the cases in which employees on vacation simultaneously claimed unemployment insurance benefits. As mentioned in a previous issue, this situation exists because the New York Court has held that under the terms of some union contracts the vacation payment is a vested right for past services and, therefore, is not to be considered as disqualifying remuneration for the vacation period.

In any event, a new session of the legislature begins in January, 1958. Since this will be an election year, no one, at the present time, can foretell what action will be taken in the unemployment insurance field. ☆

Six states make changes in unemployment tax laws

THIS MONTH seven states report changes in their unemployment compensation arrangements. They are:

Alabama—Beginning with the calendar year 1958 a uniform contribution rate will be imposed on all employees throughout the State of Alabama. The rate will be 0.1%. The employee rate will no longer be based on his employer's unemployment experience.

When the level of the unemployment fund falls below the minimum requirements, all employees will pay contributions at the rate of 0.25%.

Effective August 17 the maximum weekly benefit amount payable to an unemployed Alabama worker was raised from $25 to $28.

Wisconsin—The Wisconsin Employment

Security Law was recently amended to provide for an $11 minimum weekly unemployment insurance benefit. This was raised from a $10 weekly minimum. At the same time the law was changed to provide for a $16 average base-period weekly wage requirement in order to obtain the minimum benefit. This was raised from a $13 average weekly wage requirement.

Employers now have seven days (formerly four days) in which to reply to the Department of Employment in regard to requests for wages and employment information. A $5 penalty was written into the law to be imposed upon employers who fail to file or who untimely file information reports where the benefit determinations must be made on the basis of the claimants' statements. ☆

Illinois: Currently part-time work performed by minor students during the school year is considered exempt from contributions under the Illinois Compensation Act. This exemption will be continued throughout the calendar year 1957, but services performed by such part-time minor students will no longer be considered exempt under the Act after 1957.

Effective with respect to weeks ending on and after October 1, 1957, the maximum weekly benefit amount payable to unemployed Illinois workers will be as follows: $30, if the individual has no non-working spouse and no children; $33, if the individual has a non-working spouse and no children; $36, if the individual has one child; $39, if the individual has two children; $42, if the individual has three children; or $45, if the individual has four or more children. Prior to the change in the Law the benefits ranged from $28 to $40 weekly.

Effective July 12, 1957 the Law was changed to provide that disqualifying income for unemployment insurance purposes shall include:

1. One-half of the amount which a claimant is receiving as Federal Old-Age Benefits under the Social Security Act.

2. The entire amount which an individual is receiving in the form of a retirement benefit from an employer who bears the cost of all of such benefit.

3. One-half of the amount which an individual is receiving in the form of a retirement benefit from an employer where the employer pays some but not all of the cost of such benefit.

Wisconsin—Unemployed workers in the State of Wisconsin may now receive a maximum weekly unemployment benefit amount of $38 in accordance with a recent amendment to the Law. Prior to this change the maximum weekly benefit was $36.

This new maximum benefit becomes effective with respect to benefit determinations whose first benefit check is issued after the month following official publication of the amendment.

Wyoming—It was indicated in 6 JTAX 318 that the Wyoming Unemployment Insurance Law was changed providing for an escalator-type computation for determining the maximum weekly benefit amount payable to unemployed workers. Such maximum weekly benefit amount, in accordance with the new provision of the law, would not be less than $10 nor more than 55% of average weekly wages of insured workers.

The Wyoming Commission has determined, in accordance with the provisions of the new law, that for the period July 1, 1957 to June 30, 1958 the maximum weekly benefit was computed as $41.

Kansas—In addition to the changes to the Kansas Employment Security Law which have heretofore been mentioned, a separate bill was approved whereby Kansas employers will be allowed to make voluntary contributions into the unemployment fund in order that they may secure reduced contribution rates.

The new Law provides that such voluntary payment must be made within 30 days after the mailing date as reflected on the Annual Experience Rating Notice.

California: The California Unemployment Insurance Law was amended to provide that effective with new claims for benefits filed on and after September 11, the maximum weekly benefit amount payable to an unemployed worker will be $40. This was raised from a $33 weekly maximum.

Currently the Law provides for contribution rates ranging from 1.0% to 2.7% when the balance in the unemployment insurance fund is less than 7.1% of taxable payrolls throughout the State. Effective January 1, 1958 contribution rates will range from 0.3% to 2.7% when the level in the fund is below the 7.1% requirement. The rates ranging from 1.0% to 2.7% will continue to be in effect when the level in the fund equals or exceeds 7.1% of payrolls.

Effective September 11, the disqualification period for claimants who are found to have voluntarily left work without good cause or to have been discharged from work for misconduct will be a flat 5 weeks. The disqualification period ranging from 2 to 5 weeks remains in effect until September 11.

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